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The 1994 revision of the venerable Uniform Partnership Act (UPA) and the development and rapid spread of new unincorporated business forms, including the limited liability company (LLC) and the limited liability partnership (LLP) have not only raised many new issues, but have also breathed new life into old ones. One of the most important of the latter is the extent to which fiduciary duties may be waived or modified by contract. Both the Revised Uniform Partnership Act (RUPA)[1] and the Uniform Limited Liability Company Act (ULLCA)[2] make unenforceable some contractual waivers of fiduciary duties. Although there has been some criticism of such restrictions on waivers,[3] most commentators have defended restrictions on fiduciary waivers in partnerships and LLCs that are

1. REVISED UNIF. PARTNERSHIP ACT (1994) (RUPA) § 103(b), 6 U.L.A. 16 (1995).

2. UNIF. LIMITED LIABILITY COMPANY ACT (ULLCA) § 103(b), 6A U.L.A. 434 (1995).

3. *See generally* J. Dennis Hynes, *Fiduciary Duties and RUPA: An Inquiry into Freedom of Contract*, 58 LAW & CONTEMP. PROBS. 29 (Spring 1995); Larry E. Ribstein, *A Critique of the Uniform Limited Liability Company Act*, 25 STETSON L. REV. 311 (1995); Larry E. Ribstein, *The Revised Uniform Partnership Act: Not Ready for Prime Time*, 49 BUS. LAW. 45 (1993) [hereinafter Ribstein, *Prime Time*].

at least as extensive as those in the uniform laws.[4] This commentary carries forward the long-standing debate between those who have argued that fiduciary duties are and should be essentially contractual in nature[5] and those who argue for some restrictions on waiving these duties.[6]

This issue is worth revisiting despite the substantial amount of ink that has been spilled over it. First, the debate so far has focused on publicly held corporations, where the commentators were able to make the argument, albeit a questionable one,[7] that the duties did not really arise out of contract at all. In a closely held firm, which is very much like any long-

4. *See generally* Claire Moore Dickerson, *From Behind the Looking Glass: Good Faith, Fiduciary Duty & Permitted Harm*, 22 FLA. ST. U. L. REV. 955 (1995) [hereinafter Dickerson, *Looking Glass*]; Claire Moore Dickerson, *Is it Appropriate to Appropriate Corporate Concepts: Fiduciary Duties and the Revised Uniform Partnership Act*, 64 U. COLO. L. REV. 111 (1993); Allan W. Vestal, *Advancing the Search for Compromise: A Response to Professor Hynes*, 58 LAW & CONTEMP. PROBS. 55 (Spring 1995) [hereinafter Vestal, *Response*]; Allan W. Vestal, *Fundamental Contractarian Error in the Revised Uniform Partnership Act of 1992*, 73 B.U. L. REV. 523 (1993) [hereinafter Vestal, *Error*]; Allan W. Vestal, *The Disclosure Obligations of Partners* Inter Se *Under the Revised Uniform Partnership Act of 1994: Is the Contractarian Revolution Failing?*, 36 WM. & MARY L. REV. 1559 (1995) [hereinafter Vestal, *Revolution*]; Donald J. Weidner, *RUPA and Fiduciary Duty: The Texture of Relationship*, 58 LAW & CONTEMP. PROBS. 81 (Spring 1995).

5. *See generally* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 1-39 (1991); Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1 (1990); Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425 (1993) [hereinafter Easterbrook & Fischel, *Contract*]; Richard A. Epstein, *Contract and Trust in Corporate Law: The Case of Corporate Opportunity*, 21 DEL. J. CORP. L. 1 (1996).

6. *See generally* Alison Gray Anderson, *Conflicts of Interests: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. REV. 738 (1978); Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985); Robert Charles Clark, *Agency Costs versus Fiduciary Duties*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55 (J. Pratt & R. Zeckhauser eds., 1985); John C. Coffee, Jr., *No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOK. L. REV. 919 (1988) [hereinafter Coffee, *No Exit?*]; John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 (1989) [hereinafter Coffee, *Mandatory/Enabling Balance*]; Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879; Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211 (1995) [hereinafter Eisenberg, *Limits*]; Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461 (1989); Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795 (1983); Lawrence E. Mitchell, *The Death of Fiduciary Duty in Close Corporations*, 138 U. PA. L. REV. 1675 (1990); Robert B. Thompson, *The Law's Limits on Contracts in a Corporation*, 15 J. CORP. L. 377 (1990); Ernest J. Weinrib, *The Fiduciary Obligation*, 25 U. TORONTO L.J. 1 (1975).

7. *See* Butler & Ribstein, *supra* note 5, at 12-15.

term contract, that argument is untenable. Second, the debate has focused on *corporations*. Partnerships and other unincorporated firms differ from corporations in several ways that are relevant in the present context, including the absence of rhetoric implying that the firm is a "creature" of state law, a general assumption that the parties' contract controls all important elements of the relationship among the members, and idiosyncratic and highly customizable terms that make mandatory duties particularly costly in this context. Third, the anticontractarians have made assertions about the present state of the positive law that no one so far has seriously refuted.

This Article's basic premise is the one forcefully stated by Easterbrook and Fischel, who assert that fiduciary duties are simply a species of contract, "not a distinctive topic in law or economics."[8] They show how a transaction cost economics approach, which views fiduciary duties as presumptive contract rules, better explains the positive law of fiduciary duties, particularly including the variation across different relationships, than do noncontractarian approaches that attempt to identify fiduciary duties as a distinctive set of absolute duties. The present Article shows how this analysis applies to fiduciary duty waivers in unincorporated firms.

This Article then moves beyond the Easterbrook-Fischel analysis in two respects. First, it refutes specific arguments against enforcement of fiduciary duty waivers whether or not these waivers are characterized as contracts. Although my prior analysis of fiduciary duties in public corporations relies primarily on theories and evidence of public securities market discipline of corporate contracts,[9] the present Article shows that arguments for protecting individuals from potentially bad bargains in the context of one-on-one bargaining in closely held firms are unfounded. Second, this Article extensively analyzes cases relating to partnership fiduciary duties. It shows that anticontractarians have misconstrued the positive law of partnership and that restrictions in RUPA and the ULLCA would reverse long-standing case law favoring the enforcement of contracts.

The Article proceeds as follows. Part I states the affirmative case for enforcing contracts in unincorporated firms that is based primarily on the inability of mandatory rules to cope with the significant variability of contracts in this context. Part II then unpacks and refutes the arguments of

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8. Easterbrook & Fischel, *Contract*, *supra* note 5, at 446. This view is consistent with a prominent commentator's recent analysis of trust law. *See* John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 YALE L.J. 625, 629 (1995) (stating that "despite decades of pulpit-thumping rhetoric about the sanctity of fiduciary obligations, fiduciary duties in trust law are unambiguously contractarian").

9. *See generally* Butler & Ribstein, *supra* note 5.

the anticontractarians against contract enforcement. Part III discusses the case law support for enforcing fiduciary duty waivers in partnerships.

I. The Case for Contract

Anticontractarians tend to emphasize only the arguments against enforcing contracts without adequate consideration of the benefits of contracts in general and fiduciary duty waivers in particular. Even some contractarian commentators slight this part of the equation. One recent article in support of the contractual theory of partnership fiduciary duties asserts that fiduciary duty contracts should be enforced because contracts are important and the parties ought to be able to rely on them.[10] This provides an easy target for anticontractarians, who can counter with their own assertion that, even if fiduciary duties are contractual, waivers of fiduciary duties should not be enforced on efficiency or other grounds.[11] The normative case for enforcing contracts therefore must articulate the economic costs and offsetting benefits of not enforcing fiduciary duty contracts. That is the main task of this Part, after first summarizing the theoretical basis of the contractarian approach to fiduciary duties.

A. Fiduciary Duties as a Hypothetical Bargain

Fiduciary duties can be characterized as a hypothetical bargain — that is, contract terms the parties themselves would have agreed to in the absence of transaction costs.[12] This approach to fiduciary duties finds explicit support in the case law.[13] Anticipating the parties' own deal makes

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10. *See* Hynes, *supra* note 3, at 38 (stating that "[m]andatory provisions are inconsistent with the bargain principle" of contract law). Professor Hynes demonstrates the vulnerability of his argument by his lone citation in support of the "bargain principle" — an article by a leading anticontractarian on the fiduciary duties issue. *See id.* at 38 n.44 (citing Melvin Aron Eisenberg, *The Bargain Principle and Its Limits*, 95 HARV. L. REV. 741, 742 (1982)).

11. *See* Lawrence E. Mitchell, *The Naked Emperor: A Corporate Lawyer Looks at RUPA's Fiduciary Provisions*, 54 WASH. & LEE L. REV. 465, 480-86 (1997).

12. *See* Easterbrook & Fischel, *Contract*, *supra* note 5, at 427.

13. For a prominent example involving opinions by Judges Easterbrook and Posner, see *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429 (7th Cir. 1987), discussed *infra* text accompanying notes 26-28. Delaware Chancellor Allen has applied this reasoning and concluded that a partner had no right to information in aid of a consent solicitation that might injure the partners' joint investments in the firm by "[i]magin[ing] individuals negotiating the terms of a partnership agreement with respect to access to information." Schwartzberg v. CRITEF Assocs., 685 A.2d 365, 376 (Del. Ch. 1996). Chancellor Allen here applied his earlier hypothetical bargain reasoning in *Katz v. Oak Industries, Inc.*, 508

sense as a way of economizing on contracting costs *only* if the parties could make their own alternative deal. Otherwise, the court might as well supply its own idea of the "right" contract terms regardless of whether the parties would have wanted them. Thus, the application of hypothetical bargain reasoning to fiduciary duties suggests that these duties are waivable. Nevertheless, it is important to keep in mind the difference between hypothetical and actual bargains. This subpart explores in more detail the basis and limits of the hypothetical bargain analysis, with particular focus on its implications for fiduciary duty waivers.

1. The Basic Duty of Unselfishness

The nature of the fiduciary duty hypothetical bargain was described in the classic statement by Judge Cardozo in *Meinhard v. Salmon*:[14]

> Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.[15]

As Justice Cardozo's statement makes clear, fiduciaries owe a duty of unselfishness. Rather than the self-interest that the law permits in most contractual relationships, fiduciaries owe "something stricter than the morals of the market place." This duty fits the bargain that many fiduciaries and beneficiaries would likely make in the absence of transaction costs. The beneficiary is willing to trust the fiduciary's discretion because the fiduciary's skills can enhance the value of the beneficiary's property.[16] Yet an unconstrained fiduciary might selfishly diminish rather than increase the value of the beneficiary's property. Because this would be a bad deal for the beneficiary, the law assumes a contract that, as Justice Cardozo said, requires the fiduciary to sacrifice his advantage to that of the beneficiary.

A.2d 873, 880-82 (Del. Ch. 1986).

14. 164 N.E. 545 (N.Y. 1928).

15. Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928) (citation omitted).

16. *See* Anderson, *supra* note 6, at 744.

2. *Limits on Unselfishness*

The hypothetical bargain analysis is useful not only in explaining why fiduciary duties should be recognized in some relationships, but also in showing why they should be modified or not even recognized in others.[17] Because no one is bound to become a fiduciary in the first instance, a beneficiary must pay a fiduciary to be selfless.[18] Whether a hypothetical fiduciary duty bargain is justified depends on whether selfless conduct by the fiduciary in a particular context is likely to be worth the price the beneficiary would have to pay. For example, if the fiduciary-to-be believes that there is a 50% chance of having to forgo a deal worth $100,000, this represents a $50,000 opportunity cost (ignoring the time value of money) of becoming a fiduciary.[19] The fiduciary-to-be similarly would take into account the need to devote time unselfishly to the business. Before making the leap to fiduciary status, the fiduciary-to-be would want to be assured of being compensated for these sacrifices. The beneficiary, in turn, would be willing to compensate the fiduciary for forgoing self-advantage only if this would produce an adequate payoff. The deal the parties are likely to reach will depend on the costs and benefits of fiduciary duties discussed below,[20] such as whether the fiduciary's conduct can be more cheaply constrained by restricting the fiduciary's power to act for the beneficiary. The extent of selflessness for which the parties will contract also depends on the costs of enforcing fiduciary duties. Litigation can be costly, time-consuming, and error-prone. As a result, the beneficiary may consent to restrictions on litigating, such as a rule that requires the parties to end their relationship as a precondition to litigating disputes among themselves.[21] The costs of enforcing fiduciary duties may lead the parties to substitute other constraints on the fiduciary's conduct, including compensation, exit, and control rules. This analysis explains why partners do not have default fiduciary duties in connection with all aspects of their relationship with each other. For

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17. *See* Easterbrook & Fischel, *Contract*, *supra* note 5, at 432-34 (showing how differences in costs and benefits of fiduciary duties in different contexts explain differences among firms in default nature of fiduciary duties).

18. *See id.* at 428.

19. Although it is unrealistic to suppose that anyone will be able to calculate these opportunity costs, it is not unrealistic to suppose that one would make some sort of rough calculation of what one is forgoing in entering into the relationship. The numbers are given only to concretize the example.

20. *See infra* Parts I.C-D.

21. *See generally* Saul Levmore, *Love It or Leave It: Property Rules, Liability Rules, and Exclusivity of Remedies in Partnership and Marriage*, 58 LAW & CONTEMP. PROBS. 221 (Spring 1995).

example, partners can dissolve the partnership or exercise a power under the partnership agreement to expel another partner as long as these partners do not act in bad faith.[22] Good faith is not a general duty to act unselfishly, but rather is a more limited mechanism for applying other specific partner rights under the agreement.[23] It makes good sense not to scrutinize exercise of dissolution or expulsion powers under the exacting fiduciary standard because partners need to be able freely to exercise such powers in order to protect themselves from the abuses of their associates and managers. Indeed, as discussed below,[24] the partners' ability to exit the relationship and remove copartners may determine their need to be protected by fiduciary duties. Thus, constraining partners' ability to exercise self-help would increase their vulnerability to precisely the same fiduciary abuses against which fiduciary duties are supposed to protect. The hypothetical bargain recognizes that partners normally would not want to pay their copartners enough to force them to submit decisions concerning exit and expulsion to close scrutiny under the fiduciary standard.

3. *Hypothetical Versus Actual Bargains*

The hypothetical bargain analysis raises questions about the extent to which courts do and should enforce the parties' *actual* rather than *hypothetical* bargain. What courts are doing is obscured by the facts that the parties never contract in complete detail and that the contours of the hypothetical bargain depend on the same costs and benefits that motivate partners to waive or to modify default fiduciary duties by explicit agreement. A highly specified agreement that does not include an explicit waiver may mean that the parties did not want fiduciary duties, standard duties, or a hypothetical bargain modified to suit their particular relationship.[25] This ambiguity gives courts significant leeway in interpreting agreements. For example, in *Jordan v. Duff & Phelps, Inc.*,[26] Judge Easterbrook held that a default duty to disclose an impending merger to shareholders who were selling their stock to the firm was not waived by an actual contract that denied

22. *See* 2 ALAN A. BROMBERG & LARRY E. RIBSTEIN, BROMBERG & RIBSTEIN ON PARTNERSHIP § 7.02, at 7:17-7:18 (1988) (discussing exercise of dissolution power); *id.* § 7.02, at 7:28-7:29 (discussing exercise of expulsion power).

23. *See infra* Part III.B.3.

24. *See infra* Part I.C.

25. The approach of courts to interpreting partnership agreements that do not include explicit waivers is discussed in *infra* Part III.B.1.

26. 815 F.2d 429 (7th Cir. 1987). For other discussions, see DeMott, *supra* note 6, at 882-85.

employee-shareholders the usual rights of shareholders.[27] Judge Posner argued in dissent that the actual contract should control.[28] Judge Easterbrook later clarified his own view: "People write things down in order to assign duties and allocate risks — functions vital to economic life yet defeated if courts prefer hypothetical bargains over real ones or use the ambiguities present in all language to frustrate the achievement of certainty."[29]

The question of when, in Judge Easterbrook's words, courts should "prefer hypothetical bargains over real ones" depends on the value of contractual assignments of risk and allocations of duty discussed below in Part I.C and on the strength of the arguments against enforcing contracts discussed below in Part II. In short, the hypothetical bargain analysis alone does not provide a complete or easy answer to questions concerning what courts do or should do about fiduciary duty waivers.

B. *The Inevitability of Contract*

Easterbrook and Fischel note not only that default fiduciary duties mirror parties' actual bargains, but also that "[a]ctual contracts [concerning fiduciary duties] always prevail over implied ones."[30] In other words, contracts adjust to any rules imposed by courts or legislatures. Thus, enforcing fiduciary duty opt-outs is, in Easterbrook and Fischel's words, "all but inevitable."[31] As discussed below in Part III, parties to agency relationships can, among other things, vary the fiduciary duty waiver to narrowly avoid the prohibited language, use compensation or other devices to accomplish effects similar to waiver,[32] form under a state law that is more receptive to opt-outs, or select a different type of relationship that does not impose mandatory duties. Given enforcement of most contract terms, regulation of specific contract terms, however normatively justified, may be trivial.[33]

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27. Jordan v. Duff & Phelps, Inc., 815 F.2d 429, 436 (7th Cir. 1987).

28. *Id.* at 444 (Posner, J., dissenting).

29. Continental Bank, N.A. v. Everett, 964 F.2d 701, 705 (7th Cir. 1992) (holding that bank secured creditor had no implied duty to disclose riskiness of collateral to guarantor).

30. *See* Easterbrook & Fischel, *Contract*, *supra* note 5, at 427.

31. *See id.* at 431.

32. *Cf.* Vestal, *Revolution*, *supra* note 4, at 1591-92 (noting that list of nonwaivable provisions in RUPA Section 103(b) is exclusive, thereby permitting waiver of other provisions).

33. For more extensive discussions of the "triviality" of business association rules, see Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542 (1990), and Larry E. Ribstein, *Efficiency, Regulation and Competition: A Com-*

Nevertheless, courts and legislatures can and do make contracting more difficult. Alternative permitted arrangements are not completely fungible with agreements that are not enforced. For example, organizing under the law of another state imposes a cost of doing business as a "foreign" entity that may be a significant portion of a closely held firm's operating costs. Thus, the normative question of which rules ought to be mandatory, while perhaps not as important as it might seem on the surface, is not trivial.

C. Varying Benefits of Fiduciary Duties: Alternative Constraints

Because there are many situations in which it would be in the parties' interest to waive default fiduciary duties, the "uncompromising rigidity" of fiduciary duties imagined by Justice Cardozo is unworkable. As Easterbrook and Fischel point out, mandatory rules may force the parties to enter into inefficient bargains.[34] The efficiency of a fiduciary waiver can be fully evaluated only by analyzing the entire contract rather than by looking at the waiver in isolation. The beneficiary presumably will not be willing to pay the fiduciary to forgo self-advantage if the latter is otherwise constrained to act in a manner that is not too detrimental to the beneficiary.[35] The following are some examples of how the benefits of fiduciary duties may vary in different contexts.

(1) The narrower the discretion delegated, the narrower the duty of unselfishness the parties will need. For example, the beneficiary may give a fiduciary (say, a stock broker) an immediate order to buy or sell at a specific price rather than a "limit" order to buy or sell when the market price hits a specific target. The broker is still a fiduciary in this situation and therefore must use due care in exercising the order and refrain from charging excess commissions or markups. But the specific nature of the order eliminates the problem of the fiduciary's preventing the execution of the limit order by engaging in transactions for his own account.[36]

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ment on Easterbrook & Fischel's Economic Structure of Corporate Law, 87 NW. U. L. REV. 254 (1992).

34. *See* Easterbrook & Fischel, *Contract*, *supra* note 5, at 431; *see also* Ribstein, *Prime Time*, *supra* note 3, at 58 (briefly listing types of efficient deals that may be precluded by mandatory rules).

35. *See* Butler & Ribstein, *supra* note 5, at 18-53 (discussing contractual and market constraints on managers' conduct); Dickerson, *Looking Glass*, *supra* note 4, at 985 (discussing such constraints as limiting actual conflicts that exist between fiduciaries and beneficiaries); Thompson, *supra* note 6, at 379 (noting that existence of constraints affects level of fiduciary duties that is appropriate in particular relationship).

36. *See In re* E.F. Hutton & Co., Exchange Act Release No. 25,887, 41 SEC Docket 413 (July 6, 1988).

(2) The beneficiary can reduce agency costs by monitoring and restricting transactions entered into by the fiduciary. Fiduciary duties may be appropriate for firms with dispersed, passive owners for whom active monitoring is impractical. But in some firms, such as many closely held firms, the beneficiary may have both an ability and a need to monitor whether or not the fiduciary is subject to fiduciary duties. For example, the beneficiary may have idiosyncratic preferences about what actions the firm should take and therefore would seek to control the fiduciary even if fiduciary duties eliminated all possibility of harmful selfish behavior. Accordingly, strict fiduciary duties in such firms may be unnecessarily costly.

(3) The fiduciary's conduct may be better constrained through contractual provisions that are designed for particular types of firms and relationships. These include forbidding the fiduciary from engaging in certain types of potentially harmful activities or compensation that aligns the fiduciary's incentives with the beneficiary's interests.[37]

(4) The beneficiary may be able to discipline the fiduciary through a power to exit the relationship. A corporate shareholder can sell stock, a partner can dissolve at will, and a principal can terminate an agency relationship at any time. The power to exit may sometimes be a fully effective constraint. To be sure, the power to exit may not in itself redress pre-exit misconduct. However, exit can deny the fiduciary any future gains from the relationship. Although this alone may not be enough to prevent a fiduciary from making a large one-time gain, the threat of exit may give a fiduciary an incentive to avoid less pronounced shirking. At the same time, even the threat of criminal fiduciary liability may not be fully effective.

(5) The beneficiary may be able to remove the fiduciary. The impact of this removal on the fiduciary will depend on how much the fiduciary has invested in the relationship in specific human capital or otherwise. The risk of losing a substantial investment may powerfully constrain the fiduciary's conduct.

(6) The fiduciary may have reputational incentives to act in the beneficiary's interests. Bank trustees and promoters of real estate, venture

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37. *See* Paul Gompers & Josh Lerner, *The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements*, 39 J.L. & ECON. 463, 473 (1996). Gompers and Lerner summarize various types of covenants that have been used to constrain the discretion of managers of venture capital partnerships. *Id.* at 480-84. Covenants controlling managers' conduct have also been used to protect creditors. *See generally* Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117 (1979). In this case, the covenants stand as the creditors' only protection because courts generally do not recognize fiduciary duties in this context. *See infra* note 276 and accompanying text.

capital, and other types of investment syndicates are judged in succeeding transactions by their records in prior deals.[38] Thus, even if the fiduciary can cheat a given firm without legal consequences, inadequate performance could reduce the price of the fiduciary's services in other deals.

(7) Nonmanagerial owners of firms may choose to rely on third-party monitoring. For example, default or contract rules limit the managers' agency power to bind the firm to major transactions that often involve self-dealing, such as guarantees of the managing partner's loans. Such rules force sophisticated third parties, such as banks and other lenders, to determine whether the transaction will harm the beneficiary before relying on the firm's credit.[39]

D. *Varying Costs of Fiduciary Duties*

The costs, like the benefits, of fiduciary duties may vary from firm to firm. These potential costs provide reasons for substituting the alternative constraints on fiduciary conduct discussed in Part I.A. The following are some ways in which the costs of fiduciary duties may vary.

(1) Fiduciaries have varying costs of forgoing opportunities outside the firm. Strict rules on conflicts of interest and partnership opportunities may be particularly costly for the fiduciary, such as a real estate syndicator, who must balance extensive outside interests. On the other hand, such constraints may be relatively necessary when the nature of the firm's activities makes it particularly difficult for the beneficiary to monitor the fiduciary.[40]

(2) Firms and insiders have potential scope economies of information in buying from and selling to each other by reason of information acquired in their other dealings. Insiders therefore can charge a lower risk premium than outsiders in transacting business with the firm. At the same time, an

38. *See* Gompers & Lerner, *supra* note 37, at 473 (noting that need for covenants' controlling conduct of managing partners of venture capital funds diminishes as managers are increasingly constrained by reputational concerns). On the role of reputational constraints on opportunistic conduct generally, see Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615 (1981); Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978); and Oliver E. Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 AM. ECON. REV. 519 (1983).

39. *See* Deborah A. DeMott, *Our Partners' Keepers? Agency Dimensions of Partnership Relationships*, 58 LAW & CONTEMP. PROBS. 109, 131-34 (Spring 1995).

40. *See* Gompers & Lerner, *supra* note 37, at 473 (noting that covenants restricting activities of managers of venture capital partnerships may be more necessary for funds that invest in early-stage and high-technology companies for which accounting and other information is unreliable or unavailable).

insider-debtor may be a better credit risk because the firm has both more information about the insider and more leverage because it can discipline misconduct through expulsion or other means. The firm also may have specialized needs for property and services that only an owner can supply. A mandatory rule against self-dealing would sacrifice these potential benefits of dealing with insiders because a fiduciary who must forgo all gain in the transaction would have no incentive to deal with the firm. Although the firm might be able to compensate the creditor- or lessor-owner or manager by a larger profit share, this would be a second-best alternative to directing the compensation to particular transactions. Moreover, the fiduciary might be denied valuable remedies such as loan foreclosure or lease termination that would be available to one who is dealing as a nonfiduciary.

(3) Fiduciary duties arise in relationships in which it is in the beneficiary's interest to delegate open-ended decisionmaking power to the fiduciary.[41] Yet fiduciary duties can undermine the main purpose of delegating power to the fiduciary by impeding the fiduciary's exercise of discretion.[42] In particular, a duty of care may force the fiduciary to refrain from conduct that may be construed to have been unduly risky if, ex post, the conduct is unprofitable. This is particularly a problem in firms that have passive, limited liability investors whose investment in the firm is part of a diversified portfolio. In this situation, placing the risk of failure on a single nondiversified manager may cause the fiduciary to act more cautiously than the members would prefer.[43]

(4) Prohibiting waivers may preclude efficient compensation arrangements. Awarding the fiduciary a piece of the firm's overall profits may not spur the specific efforts that the firm wants from the fiduciary. For example, a professional firm might incentivize its members by allowing them to keep the fruits of their relationships with their "own" clients, including investments in the clients. Or a firm may let fiduciaries trade on information created by their efforts[44] or keep some of the opportunities they discover in the course of their searches on behalf of the firm.[45] Prohibiting

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41. *See* Langbein, *supra* note 8, at 640 (observing that fiduciary duties first arose in trust relationships when new uses of trusts made it beneficial to expand trustees' powers).

42. *See* Anderson, *supra* note 6, at 749.

43. As a result, fiduciary duties may be more costly precisely in situations in which they are most beneficial because of beneficiaries' inability to monitor. *See supra* Part I.C.

44. *See* HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET 138-41 (1966); Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 858 (1983).

45. *See* Easterbrook & Fischel, *Contract*, *supra* note 5, at 437.

such contracts may force the firm to provide for second-best methods of incentivizing the fiduciary.

(5) Fiduciary duties may be costly not only because of the potentially perverse impact of the duties themselves, but also because of the costs of enforcing them,[46] including the direct costs of litigation and the indirect costs of disrupting the relationship. High enforcement costs help to explain why partnership law historically has permitted fiduciary duty litigation among partners only in the course of a global resolution of partnership affairs.[47] For example, a law firm may want to delegate full discretion over lawyer compensation to a committee because a fiduciary duty would inevitably lead to litigation over the "fairness" of compensation awarded. The members could rely on their exit power to constrain the managers' discretion.

II. Arguments Against Enforcing Fiduciary Duty Waivers

In light of Part I's discussion of the potential costs of fiduciary duties in particular settings and the consequent benefits of fiduciary duty waivers, there ought to be at least a strong presumption in favor of enforcing such waivers. This Part considers whether there may be offsetting deficiencies in the contracting process that might justify not enforcing waivers despite their potential benefits. The anticontractarians' arguments in favor of such deficiencies have a different flavor in unincorporated firms than they do in the debate over waiver of fiduciary duties in publicly held corporations.[48] In the latter context, the anticontractarians focus on passive investors' unthinking acceptance of terms embodied in a remote publicly filed charter. The antiwaiver argument is a harder sell in most closely held unincorporated firms in which terms are often negotiated or voted on face-to-face and approved unanimously.[49] Fiduciary waivers in unincorporated firms closely resemble the sort of "real" contracts that anticontractarians have held out as models in the public corporation debate. Accordingly, it is not surprising that the arguments against freedom of contract now must shift ground

46. *See generally* Kenneth B. Davis, Jr., *Judicial Review of Fiduciary Decisionmaking — Some Theoretical Perspectives*, 80 NW. U. L. REV. 1 (1985); Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261 (1986).

47. *See* Levmore, *supra* note 21, at 242-43.

48. As to the latter debate, see generally Butler & Ribstein, *supra* note 5.

49. Indeed, some anticontractarian commentators have stressed the greater enforceability of contracts in the context of the closely held firm. *See* ROBERT CHARLES CLARK, CORPORATE LAW 233-41 (1986); Victor Brudney & Robert Charles Clark, *A New Look at Corporate Opportunities*, 94 HARV. L. REV. 997, 1001-20 (1981).

to such factors as defects in reasoning or in the bargaining process. The difference is that anticontractarians must show that these defects are so pronounced for fiduciary waivers as to distinguish them from contracts that are normally enforced. This Part unpacks the arguments that anticontractarians make against enforcement of fiduciary duty waivers in unincorporated firms and shows that they are unpersuasive.

A. *Ex Post Harm to the Beneficiary*

One justification that has been given for refusing to enforce a fiduciary duty waiver is simply that the beneficiary may be harmed by the fiduciary's conduct.[50] This is obviously misguided. It is no different from arguing that a contract should not be enforced simply because one party experiences regret in the sense that the contract's ultimate consequences favored one party rather than the other. This approach is fundamentally inconsistent with the theory of bargained-for exchange that underlies contract law. As in any other contract, the parties bargain ex ante for the terms, including the price, in light of their expectations of potential outcomes. Thus, because of the beneficiary's expectation that the fiduciary may cheat or shirk, the fiduciary may have to give up compensation or power or give the beneficiary an exit right in return for the beneficiary's giving up fiduciary remedies. Each party's promises presumably have value to the other. The parties themselves are in the best position to determine how to optimize agency costs in a particular relationship. Ex post decisionmaking would eliminate parties' incentives to make these agreements. In short, any justification for not enforcing fiduciary duty waivers must be based on the circumstances at the time of entering into the contract and not merely on how the contract turned out.

B. *Unknowable or Unforeseeable Risks*

Some commentators have emphasized that waivers are intended to operate over a long time period, during which much can happen that the parties cannot foresee at the time of contracting.[51] This means that parties to fiduciary waivers may not be able to accurately price the risk they are taking or to cheaply ensure that the risk is not unmanageably large.[52] In

50. *See* Weidner, *supra* note 4, at 102.

51. *See generally* Brudney, *supra* note 6; Coffee, *No Exit?*, *supra* note 6; Thompson, *supra* note 6.

52. *See* Hynes, *supra* note 3, at 44-45. Hynes says that the waiver itself is a signal of a problem of untrustworthiness. However, the opposite inference also could follow —

other words, there is an asymmetry of information between fiduciaries, who presumably have extensive information about their future conduct, and beneficiaries, who do not know what fiduciaries will do. As a result, the contract may not efficiently allocate resources in the sense of maximizing the contracting parties' utility. This argument is particularly noteworthy in the present context because it was emphasized by Professor Melvin Eisenberg in a letter to the National Conference of Commissioners on Uniform State Laws (NCCUSL) that may have influenced the Commissioners to insert mandatory fiduciary duties into RUPA.[53]

There are several problems with this argument. First, the argument overstates the beneficiary's ignorance. The beneficiary is aided by numerous signals concerning the fiduciary's future actions, including the fiduciary's reputation and the other constraints on fiduciary conduct discussed in Part I.[54] Second, the asymmetric information argument is breathtakingly broad. Because information is inherently costly, ignorance is a possibility in every contract, depending on how much the parties want to spend to be informed.[55] Because there is no reason to believe that both parties will be equally ignorant, their information is obviously asymmetric. This is true not only of fiduciary duty waivers, but also of compensation, governance, exit, and other terms of business associations. Most important, the argument could apply to fiduciary duties, the costs of which may be unknowable over the course of the relationship.[56]

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that is, that there are enough assurances of trustworthiness that fiduciary duties are unnecessary.

53. *See* Letter of Professor Melvin Eisenberg to NCCUSL 2-4 (July 17, 1992), *discussed in* Hynes, *supra* note 3, at 37 n.38; Ribstein, *Prime Time*, *supra* note 3, at 59 n.103.

54. Sellers or borrowers can signal the extent of risks by, for example, offering to sell their products at a lower price without a warranty. *See* Alan Schwartz, *Legal Implication of Imperfect Information in Consumer Markets*, 151 J. INSTITUTIONAL & THEORETICAL ECON. 31, 42, 44 (1995). However, contracting parties may send inefficient signals because of wealth differences or because they know consumers will not buy protection at any price. *See id.* at 45-46 (noting that legislators cannot obtain sufficient information to regulate signals efficiently). Also, sellers or borrowers may overcommit assets to signaling in order to avoid adverse inferences from failing to send signals. *See* Philippe Aghion & Benjamin Hermalin, *Legal Restrictions on Private Contracts Can Enhance Efficiency*, 6 J.L. ECON. & ORG. 381, 382 (1990). The latter commentary indirectly supports a no-duty default rule because it suggests that parties may fail to waive fiduciary duties even when such waivers are efficient in order to avoid sending a false signal of unreliability. *Cf.* Hynes, *supra* note 3, at 44-45 (noting possibility of negative inferences). Detailed examination of this issue is outside the scope of this Article.

55. *See generally* George J. Stigler, *The Economics of Information*, 69 J. POL. ECON. 213 (1961).

56. *See supra* Part I.D (discussing costs of fiduciary duties).

Third, and most important, the asymmetric information argument is unconvincing because it is not apparent why the parties cannot and do not contract in light of their information costs and deficiencies. Confronted with an unknowable risk from waiving fiduciary duties, the parties will price the term accordingly or draft a more specific provision.[57] This is based on the concept of "bounded rationality" — that is, that people can and do act (and contract) in view of their limitations.[58] This principle helps to explain the *default* rule of fiduciary duties. A principal delegates control to an agent because the principal knows that she lacks specialized information, and then contracts to bind the fiduciary by fiduciary duties because she knows that she may not be able fully to protect herself from the fiduciary's actions given the information disparity.[59] That principals know enough to enter into these bargains suggests that they know enough to contract around these bargains in appropriate cases.[60]

C. Cognition and Rationality Constraints

Perhaps recognizing that mere lack of information or knowledge should not prevent enforcement of contracts that inherently operate into the unknowable future, some anticontractarians — particularly Professor Eisenberg — have moved beyond unforeseeability to emphasize cognition problems that prevent complete processing of information, and therefore cause people to make contracts that are irrational in light of what they know.[61] For example, Eisenberg cites evidence that people are unrealistically optimistic about the nonoccurrence of such risks as product injuries and a marriage partner's likelihood of nonpayment of alimony;[62] tend to "frame" choices so as to make irrational distinctions between risk associated

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57. The information asymmetry argument may justify setting the *default* rule to encourage contracting parties to reveal information. *See* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 91 (1989). Once this default rule is set, the waiver provides the requisite signal. *But see supra* note 54 (discussing how default fiduciary duties may send misleading signals).

58. *See* Herbert A. Simon, *A Behavioral Model of Rational Choice*, 69 Q.J. ECON. 99, 101 (1955). These limitations may include lack of information or capacity or distorted reasoning. *See* Kenneth E. Scott, *Bounded Rationality and Social Norms*, 150 J. INSTITUTIONAL & THEORETICAL ECON. 315, 315 (1994). Information problems are discussed above in Part II.A, while cognition and reasoning problems are discussed below in Part II.C. Bounded rationality as a separate topic refers to parties' actions in light of their limitations.

59. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 113 (4th ed. 1992).

60. Dean Weidner ignores this concept. *See* Weidner, *supra* note 4, at 100 n.84 (citing Posner).

61. *See generally* Eisenberg, *Limits*, *supra* note 6.

62. *Id.* at 216-18.

with gain and risk associated with loss;[63] make decisions based on information that is "readily available" to their minds rather than in light of a balanced set of information;[64] erroneously assume that a small sample of present events represents, and so accurately predicts, future events;[65] and systematically underestimate or overestimate risks such as floods or earthquakes.[66] According to Eisenberg, "[g]iven the limits of cognition, the core duty-of-loyalty rules should not be subject to a general waiver."[67] Among other things, beneficiaries would be unduly optimistic about the probability of fair conduct by managers and would irrationally assume that their present good relationships will continue into the future.

Eisenberg's article is part of a much broader literature that stresses limits on rationality as justification for paternalistic constraints on contracting.[68] Eisenberg's analysis at least has the virtue of relating fiduciary duty waivers in firms to contracts generally. However, it is important to note that the problems Eisenberg discusses appear to be much more pervasive, and to affect many more people, than the more serious limitations on judgment that undermine the individual autonomy that is essential for free contracting.[69]

First, it is not clear whether people are, in fact, irrational or whether they are acting rationally in light of limited or costly information. For example, "availability" may just mean that in some circumstances it is not worth it to acquire additional information. Also, that people miscalculate risks in an experimental setting does not mean that they will do so when the benefits of a more precise calculation outweigh the costs — that is, when they are deciding whether to insure or to opt out of fiduciary duties.

Second, even if *individuals* are irrational, it does not follow that entire markets are irrational as well.[70] Even if some investors irrationally downplay risks, fiduciaries are constrained not to offer inefficient waivers by

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63. *Id.* at 218-20.

64. *Id.* at 220-21.

65. *Id.* at 222.

66. *Id.* at 223.

67. *Id.* at 249.

68. *See generally* MICHAEL J. TREBILCOCK, THE LIMITS OF FREEDOM OF CONTRACT 147-63 (1993); Paul Burrows, *Analyzing Legal Paternalism*, 15 INT'L REV. L. & ECON. 489 (1995); Anthony T. Kronman, *Paternalism and the Law of Contracts*, 92 YALE L.J. 763 (1983).

69. *See generally* Kronman, *supra* note 68.

70. The classic expression of this view is Gary S. Becker, *Irrational Behavior and Economic Theory*, 70 J. POL. ECON. 1 (1962). For a discussion of market responses to bounded rationality problems, see Scott, *supra* note 58, at 317-18.

competition for investment capital. Suppose a fiduciary, such as a general partner in a limited partnership real estate syndication, offers a contract that includes a fiduciary duty waiver whose expected costs outweigh its benefits. Suppose further that, despite the considerations discussed in the preceding subpart, some investors fail adequately to assess the disadvantages of the waiver. If *some* offerees do correctly assess the risks, then they will bid less for the contract with the waiver than for comparable contracts without it. Unless the fiduciary can price discriminate, which may be impractical in a syndication given securities disclosure and offering rules, the fiduciary would have to offer the waiver at a lower price to all investors, including the irrational ones. Thus, fiduciary waivers are likely to be priced fairly for syndications even if some investors are irrational. It further follows that investor irrationality, if it exists, is most likely to be a problem in idiosyncratic deals in which there is direct bargaining between investors and fiduciaries. Yet in this situation the parties are most likely to carefully analyze the deal. At the same time, courts may be least able to determine whether the waiver is irrational because of the uniqueness of the deal and the unavailability of a market-determined price for the waiver.

Third, any rationality and cognition problems that may exist do not justify refusing to enforce an entire class of long-term contracts. If a contract is invalid merely because one of the parties could not clearly and objectively foresee the future or did not accurately anticipate the particular result that occurred, then any executory contract is in jeopardy, including rules on voting, exit, or compensation in business associations.[71] Yet courts commonly enforce these rules, and no anticontractarian has asserted that such rules generally should not be enforced.[72] Eisenberg implies instead that the only contracts that should not be enforced are those with respect to which parties' cognitive defects would prevent them from anticipating accurately "too many" bad results. This would include waivers of fiduciary duties that would leave bargainers unprotected from too large a category of fiduciaries' self-interested abuse of their powers under the voting, exit, and other terms of the business association. Thus, Eisenberg suggests that "[a]n agreement that a specific type of business venture will not be deemed a corporate opportunity" might be enforced.[73] Yet, under Eisenberg's theory,

71. If people are too irrational to contract, it is unclear why they should be allowed to make any important choices, including voting, driving, having abortions, getting married, or having children.

72. Eisenberg, *Limits*, *supra* note 6, at 254 (asserting that cognitive defects explain rules that "allow easy exit on fair terms from thick relationships" such as partnerships without explaining why rules are not mandatory).

73. *See* Eisenberg, *Limits*, *supra* note 6, at 249.

even these investors would be unduly optimistic about the quality of the opportunities the fiduciary would be able to keep out of the firm. The apparent reason for the distinction is not that bargainers may fail rationally to assess the costs of this permitted type of contract, but rather that the parties to the contract, although irrational, are being sufficiently reasonable about their irrationality. Eisenberg must explain why some contracts are reasonable and others are not despite the fact that both are subject to cognitive defects.[74]

D. *Bargaining Defects*

If bargainers' information and cognitive deficiencies do not justify mandatory fiduciary duties, then perhaps, according to the anticontractarians, fiduciary duty waivers suffer from defects in the process by which such contracts are made.[75] The problem here is not that the parties do not understand the effect of their actions, but that they cannot do what they know they should do in order to maximize their utility.[76]

Contract terms cannot easily be *imposed* on helpless investors in closely held firms. Indeed, two prominent commentators who lean toward the anticontractarian position with respect to publicly held firms have argued that the relatively small number of owners in closely held firms normally should be deemed to be capable of giving viable consent to outside dealings.[77] Unlike, for example, automobile warranties, in which one might contend that consumers face an oligopoly that offers few contracting choices for a product most consumers need, closely held firms compete with myriad alternative investment opportunities. To be sure, investors' choice of investments may be limited in some circumstances, as when the demand for a particular type of investment exceeds the supply, and these limitations may affect investors' ability to bargain for constraints

74. In addition, Eisenberg must explain how judges can overcome rationality problems that are common to all humans in deciding which contracts are reasonable. *See infra* text accompanying notes 135-37.

75. Sometimes it is difficult to separate these arguments in the anticontractarian literature. *See* Weidner, *supra* note 4, at 100 (listing combination of cognition and bargaining problems).

76. Some commentators have argued that the power fiduciaries wield over beneficiaries should negate any waiver of fiduciary duties. *See* Dickerson, *Looking Glass*, *supra* note 4, at 993; Hynes, *supra* note 3, at 43-44 (suggesting that mutual trust in agency should weigh against opt-out, although generally arguing in favor of waivability). The obvious problem with this argument is that it fails to explain why a beneficiary should not be able to agree to a modification or waiver of fiduciary duties *before* the power arising out of the relationship is created.

77. *See supra* note 49 and accompanying text.

on fiduciaries' conduct.[78] Yet investors can always choose an alternative type of investment when their choices are less limited.

Arguments concerning bargaining problems in this context focus not on the range of choices available to contracting parties, but rather on their ability to utilize these choices in the environment in which partnership contracts are negotiated. For example, anticontractarians have noted bargainers' inclination to trust each other rather than risk aggressive negotiations that may "queer" the deal.[79] Another commentator has asserted that private ordering is hampered by the usual informality of partnership, the unsophistication of the parties and their counsel, the fact that one attorney may represent all of the parties, the parties' tendency at the outset to underestimate the risk of dispute,[80] and the frequent resort to forms.[81] But these observations explain only why bargainers will tend to accept *default* rules rather than attempt to insert idiosyncratic and possibly controversial provisions such as fiduciary duty waivers. They fail to explain why actual contracts should not be enforced.

Even if the bargaining process contains defects that cause bargainers to accept inefficient customized rules, it is not clear what mandatory rules would accomplish. If one party were inhibited from bargaining, blocking one specific contractual exit route will accomplish very little. The "superior" bargainer would simply substitute an alternative, such as a slightly more specific opt-out or higher compensation.[82]

E. Externalities

Commentators have made a variety of arguments against fiduciary duty waivers that purportedly are based on costs to people other than the parties to the waivers. First, they assert that fiduciary duty waivers will encourage managers to make socially wasteful investments in opportunistic conduct.[83]

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78. *See* Gompers & Lerner, *supra* note 37, at 469-72 (showing how amount and extent of covenants' restricting managers' conduct in venture capital partnerships depend to some extent on supply of such firms and amount of capital available for investment).

79. *See* WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE 64 (6th ed. 1996); Coffee, *Mandatory/Enabling Balance*, *supra* note 6, at 1677; Weidner, *supra* note 4, at 100 n.83.

80. This particular argument appears to refer to the cognition problems discussed above in Part II.C.

81. *See* Robert W. Hillman, *Private Ordering Within Partnerships*, 41 U. MIAMI L. REV. 425, 433-42 (1987).

82. *See* Easterbrook & Fischel, *Contract*, *supra* note 5, at 432.

83. *See* Weidner, *supra* note 4, at 101. Weidner supports this assertion by citing a discussion in POSNER, *supra* note 59, at 109-10, of socially wasteful investments in disseminating misinformation, which is a different problem from opportunism.

This is not, however, an externality at all because any "opportunistic" conduct the contract permits injures only the beneficiary, who can contract to minimize this risk. Moreover, merely because the beneficiary might have been better off under a different contract does not mean that the fiduciary's conduct is social waste. It is just as true that the fiduciary might have been better off in the sense of being able more fully to pursue her self-interest without fiduciary constraints. The question is what set of rules best balances the expected benefits to the fiduciary from exploiting opportunities that relate to the firm against the expected benefits to the beneficiary from directing the fiduciary's conduct toward the firm. The beneficiary and fiduciary can be expected to design the contract to optimize their mutual benefits. Although the parties may miscalculate in light of subsequent events, the risk of miscalculation is even greater under a mandatory rule that attempts to regulate many different types of contracts.

A second externality-based argument is that permitting fiduciary duty opt-outs may hurt parties who must incur extra costs to understand, and possibly avoid, these customized terms.[84] This argument makes little sense even in the context of publicly held corporations with standardized contract terms.[85] It makes even less sense in the context of highly variable and customized partnership agreements. In this context, checking to see whether a clause exists and shunning terms that seem to pose problems impose little additional burden on contracting. In any event, this is not an externality because the waiving firm itself incurs the supposed costs in dealing with investors. Thus, if standardization has net benefits, firms will have incentives to adopt standardized fiduciary duty opt-outs or not to waive fiduciary duties.[86]

Third, one commentator argues that enforcing fiduciary duty waivers would impact other than just the contracting parties by encouraging all business people to ignore fiduciary norms.[87] But it is not clear why this

84. *See* Coffee, *No Exit?*, *supra* note 6, at 434-50; Weidner, *supra* note 4, at 102 n.89. Weidner also notes the parties' need to invest resources to protect themselves against misrepresentations. This is unrelated to problems relating to fiduciary duty opt-outs.

85. *See* Butler & Ribstein, *supra* note 5, at 34-35 (discussing role of analysts in evaluating terms).

86. A more subtle variation on the excessive variety argument is that opting out of fiduciary duties hurts those who do not opt out by decreasing the amount of case law that might clarify the meaning of fiduciary duties. *See* Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1593-94 (1989). For criticism of this point, see Butler & Ribstein, *supra* note 5, at 56-58. Among other problems with this argument, it anomalously assumes that the standard term would die out without regulatory protection — that is, that opting out would become *too* popular.

87. *See* Claire Moore Dickerson, *Cycles and Pendulums: Good Faith, Norms, and the*

might happen. Indeed, there is no evidence that it has happened despite the parties' ability to opt out of fiduciary duties under current law.[88]

Fourth, and perhaps least relevant, is the assertion that allowing fiduciary duty waivers will impose costs on the legal system of remedying disappointment and opportunism.[89] The extent to which the law *should* untangle ex post disappointment is the precise question involved in enforcing fiduciary opt-outs. Indeed, the argument could be turned around in two respects. Contractual fiduciary duties impose costs on the tax-supported legal system that are not fully borne by the contracting parties. From this perspective, the externality is associated with fiduciary duties themselves and not with opt-outs. Also, not enforcing contract terms such as fiduciary duty waivers is at least as likely to create disappointment and opportunism as would enforcing these terms. In this case, the disappointment is that of the fiduciary who relied on waiver, and the opportunism is that of the beneficiary who seizes on a technical reason for nonenforcement in order to hold the fiduciary ex post to obligations the latter never agreed to undertake.

F. "Noneconomic" Considerations

A final set of arguments against enforcement of fiduciary waivers is that the case for enforcement rests on economic arguments about transaction costs and property rights that ignore important noneconomic, or at least nonefficiency, values. The basis of these arguments is not always clear. These arguments may simply restate the efficiency-based anticontractarian arguments discussed above in this Part. To the extent that the arguments are, in fact, "noneconomic," they may lead to rules that would impose real costs on society without commensurate benefits.[90]

Some commentators argue that fiduciary duty opt-outs may have unfair or unjust effects on beneficiaries.[91] This may mean that, viewed ex post, the contract gave the beneficiary cause for regret. This seems to be either a frontal attack on the basic contract principle that one should be able to bind oneself ex ante to ex post results, or simply an argument that the contracting parties' consent sometimes results from bargaining or cognition problems discussed above in this Part.[92] Either argument would require a

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Commons, 54 WASH. & LEE L. REV. 399, 401 (1997).

88. *See infra* Part III.

89. *See* Weidner, *supra* note 4, at 102-03.

90. *See* ALAN SCHWARTZ, THE LAW AND ECONOMICS APPROACH TO CONTRACT THEORY 26-28 (Columbia Law and Economics Working Paper No. 123) (criticizing noneconomic arguments against enforcing contracts on similar grounds).

91. *See* Vestal, *Response*, *supra* note 4, at 70-72.

92. *See supra* Part II.C.

court to substitute its own judgment as to what an objectively "fair" or "just" result would be.[93] Moreover, to the extent that fairness or justice is just a replay of the rationality, bargaining, and information problems discussed above, it is subject to all of the criticisms of these arguments that have been discussed.

Commentators also have suggested that mandatory fiduciary duty rules force managers to engage in behavior that is appropriate because it is ethical,[94] instills trust in beneficiaries,[95] or complies with generally accepted business norms.[96] But it is not clear what the "right" behavior is. Commentators' own conclusions are wholly subjective. One person's salutary norm of cooperation may be another's way to facilitate undesirable wealth transfers.[97] Nor is it necessarily enough to rely on statements by judges such as that by Justice Cardozo in *Meinhard*.[98] Judges are not necessarily experts on proper business behavior. They may use colorful language in order to increase their own reputations[99] or apply an elevated standard in order to bring more business disputes into court.[100] If judges are correctly interpreting business norms that have arisen spontaneously outside of court,[101] it is still not clear whether these norms are objectively "right" in any sense.[102]

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93. *See generally* David Charny, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 MICH. L. REV. 1815 (1991).

94. *See* Weidner, *supra* note 4, at 104.

95. *See* Mitchell, *supra* note 6, at 1686-88; *see also* Lawrence E. Mitchell, *Fairness and Trust in Corporate Law*, 43 DUKE L.J. 425, 429 (1993). Like the other considerations discussed in this subpart, trust does not have to be viewed as a noneconomic concept. *See generally* Oliver E. Williamson, *Calculativeness, Trust, and Economic Organization*, 36 J.L. & ECON. 453 (1993) (distinguishing between trust in economic, or "calculative," sense, and personal trust).

96. *See* Mitchell, *supra* note 95, at 430-31. *See generally* Dickerson, *supra* note 87; Allan W. Vestal, *"Assume a Rather Large Boat. . . ": The Mess We Have Made of Partnership Law*, 54 WASH. & LEE L. REV. 487 (1997).

97. *Cf.* John R. Lott, Jr., *An Explanation for Public Provision of Schooling: The Importance of Indoctrination*, 33 J.L. & ECON. 199 (1990) (arguing that public education instills views that make it easier for state to effectuate wealth transfers).

98. *See supra* text accompanying note 15.

99. *See infra* note 211 and accompanying text.

100. *See* Larry E. Ribstein, *The Mandatory Nature of the ALI Code*, 61 GEO. WASH. L. REV. 984, 1031-32 (1993).

101. For two important studies of the spontaneous creation of business norms, see ROBERT C. ELLICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES (1991) and Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55 (1963).

102. *See* Eric A. Posner, *Law, Economics, and Inefficient Norms*, 144 U. PA. L. REV.

This uncertainty about applicable norms is amply demonstrated by Professor Vestal's article in this Symposium.[103] Vestal uses the recent case of *Beasley v. Cadwalader, Wickersham & Taft*,[104] which awarded substantial compensatory and punitive damages to a partner who was expelled by a large law firm in order to maximize profits for the remaining partners,[105] to show why it is important to maintain norms to deter conduct like that involved in *Beasley*. The court condemned the attitude of the Co-Chair of the management committee, who was quoted as saying, in part: "[L]ife is not made up of love, it is made up of fear and greed and money — how much you get paid in large measure."[106] But the issues become more complicated when the facts cited in the opinion are viewed from the law firm's perspective. From this angle, rather than expelling the plaintiff, the firm closed its unprofitable Florida office and offered the plaintiff an opportunity to move to the main office in New York.[107] The plaintiff, who had been planning to leave the firm in any event,[108] declined the offer. Even if the plaintiff was terminated, the firm may just have used the wrong procedure. As Professor Vestal points out,[109] and as was recently confirmed by the highest court in New York[110] (whose law controlled in *Beasley*),[111] the firm could have terminated the plaintiff by dissolving and re-forming without him. The firm's management committee acted not directly to enrich itself, but to prevent the firm's destruction by departure of its most productive lawyers.[112] Indeed, in talking about "greed," the Cadwalader manager was only emphasizing that the productive partners would not have stayed in the firm for "love" only, but would have left unless the management committee acted as it did to save the firm.

What, then, does *Beasley* say about the applicable norms? Do these norms permit the firm to dissolve and re-form without the partners, consis-

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1697, 1711-24 (1996) (discussing how inefficient norms may arise).

103. *See generally* Vestal, *supra* note 96.

104. 1996 WL 438777 (Fla. Cir. Ct. July 23, 1996).

105. Beasley v. Cadwalader, Wickersham & Taft, No. CL-94-8646 "AJ," 1996 WL 438777, at *8-*9 (Fla. Cir. Ct. July 23, 1996).

106. *Id.* at *7.

107. *See id.* at *2-*3.

108. Indeed, for that reason plaintiff was denied damages for lost income. *See id.* at *8.

109. *See* Vestal, *supra* note 96, at 505-06.

110. *See* Dawson v. White & Case, 672 N.E.2d 589, 591-92 (N.Y. 1996).

111. *See* Beasley v. Cadwalader, Wickersham & Taft, No. CL-96-8646 "AJ," 1996 WL 449247, at *1 (Fla. Cir. Ct. Mar. 29, 1996) (order denying motion for summary judgment, making findings of fact, and determining questions of law).

112. *See id.* at *7 (quoting Co-Chair of management committee).

tent with what the highest New York court called "the principle that partners may choose with whom they wish to be associated"?[113] If not, must the management committee stand by and watch the country's oldest law firm be destroyed by the departure of its most productive partners? If they were planning on leaving anyway, did Beasley and the other Florida partners violate any norms by holding out for a special buyout package in excess of the amount provided for in the partnership agreement,[114] knowing that their firm could not legally expel them? Would departure by the productive partners whose threat to leave supposedly provoked Beasley's termination violate norms against "greed," or instead be consistent with another arguably applicable norm, enforced by the ethics rules, of upholding client choice through unrestricted competition for legal services?[115] *Beasley* itself held that the terminated partner was entitled to relief despite his own competition against his firm in recruiting associates for his new firm, citing cases that relied on the ethical rule favoring competition.[116] The court resolved the conflict among norms in conclusory fashion by observing that "[i]f Beasley had dirt under his fingernails, CW&T was up to its' [sic] elbows in the dung heap."[117]

Even assuming that it is clear which norms are the right ones, it is not clear that they should be enforced by courts.[118] Justice Cardozo's statement

113. *See Dawson*, 672 N.E.2d at 591 (quoting Gelder Med. Group v. Webber, 363 N.E.2d 573, 577 (1977)).

114. Paragraph F of the Cadwalader, Wickersham & Taft agreement, which was attached to the Amended Complaint, provided that voluntarily withdrawing partners were entitled to their capital shares, not including their interests in accounts receivable or work in process.

115. This rule has been applied in forbidding enforcement of certain types of contractual constraints on competition by law firms against leaving partners. *See* Cohen v. Lord, Day & Lord, 550 N.E.2d 410, 411 (N.Y. 1989) (holding that agreement denying withdrawing law partner distributions from postdissolution receipts was unethical restriction on competition); Larry E. Ribstein, *Ethical Rules, Agency Costs and Law Firm Structure* (unpublished manuscript) (on file with author).

116. *See* Beasley v. Cadwalader, Wickersham & Taft, No. CL-94-8646 "AJ," 1996 WL 438777, at *6 (Fla. Cir. Ct. July 23, 1996) (citing Graubard, Mollen, Danett & Horowitz v. Moskovitz, 629 N.Y.S.2d 1009 (N.Y. 1995) and Jacob v. Norris, McLaughlin & Marcus, 607 A.2d 142 (N.J. 1992)).

117. *Beasley*, 1996 WL 438777, at *6.

118. Nor is it clear that the fiduciary norm *has* been enforced in partnerships under the UPA. *See supra* text accompanying note 22. Thus, contrary to the argument in Vestal, *supra* note 96, at 511-12, RUPA Section 404(e), which explicitly permits partners to act selfishly, did *not* change partnership law. In light of this point, Vestal's argument must be reformulated as one to *change* the legal rule in order to better promote a norm that he believes business people such as the lawyers in Cadwalader are now ignoring.

in *Meinhard*, and its repetition in countless later cases, could be no more than the statement of a standard to which business people should aspire rather than a legally enforceable rule,[119] or the overstatement of a legal rule in moralistic terms that promotes compliance.[120] The parties to a contractual relationship may subscribe to the norm, but may not want it to be legally enforced.[121] They may do so for many reasons, including that litigation is costly and disruptive and relies on facts that are not verifiable.[122] Indeed, many recent commentators have argued that legal enforcement may actually weaken or subvert norms.[123] For example, the idea that giving broad legal remedies to disgruntled or litigious business people necessarily promotes trust or cooperation in business relationships is absurdly unrealistic. Instead, it gives some uncooperative parties a club to use against other uncooperative parties. This could force parties *not* to trust their associates, but rather to draft specified agreements that blunt the litigation tool, to avoid the relationship, or to opt out of the norm altogether, thereby making it unavailable to govern even the cases for which it was designed.[124] If the rule is mandatory and the parties cannot avoid its application,[125] the parties

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119. For an analysis of Delaware management buyout cases that makes this distinction between legal rules and judicial statements of norms, see EDWARD B. ROCK, SAINTS AND SINNERS: THE PECULIAR MECHANISMS OF DELAWARE CORPORATE LAW, (University Of Pennsylvania Institute for Law and Economics, Discussion Paper No. 193, Mar. 5, 1996).

120. *See* Frankel, *supra* note 6, at 829-32.

121. *See* ELLICKSON, *supra* note 101, at 123-36; Macaulay, *supra* note 101, at 62-67.

122. *See* Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765, 1787-95 (1996).

123. *See id.* (showing how applying business norms under UCC would perversely affect commercial relationships); David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 HARV. L. REV. 375, 426-46 (1990) (arguing for legal enforcement of nonlegal commitments only in special cases); Langbein, *supra* note 8, at 658 (noting that although right behavior may converge with law in cases such as *Meinhard*, that does not mean that moral standards always should be legally enforceable); Richard H. Pildes, *The Destruction of Social Capital Through Law*, 144 U. PA. L. REV. 2055, 2060-76 (1996) (showing how law can destroy social conditions that allow development of norms of reciprocity and cooperation); Eric A. Posner, *The Regulation of Groups: The Influence of Legal and Nonlegal Sanctions on Collective Action*, 63 U. CHI. L. REV. 133, 136 (1996) (arguing that rules that duplicate norms generally undermine self-regulation); Edward B. Rock & Michael L. Wachter, *The Enforceability of Norms and the Employment Relationship*, 144 U. PA. L. REV. 1913, 1932-38 (1996) (arguing that courts should not enforce norms that are antagonistic to at-will employment).

124. *See* Bernstein, *supra* note 122, at 1796-1815. Of course, the law may preclude this result by making the norm mandatory. However, as discussed in the text immediately below, this may lead to further problems.

125. *See supra* Part I.B.

may be forced to avoid the relationship altogether. A legal rule cannot force the parties to trust or cooperate with each other, but it can reduce trust or cooperation.

Even if the norm is appropriate and should be legally enforced, it is not clear that the norm-based rule should be *mandatory*, or how broad the restrictions on contracting should be. For example, the *Beasley* punitive damage award was based largely on the absence of an expulsion clause in the agreement rather than on the general impermissibility of expulsion.[126] Assuming that there is a "norm" that firms should not expel partners to save the firm as a whole, it is not clear why all firms should be required to live by that norm. It is also not obvious why the parties themselves should not be able to decide when to adopt a legal rule because it may promote cooperation and trust, and when to reject that rule because it might be used to promote wasteful litigation. Mandatory fiduciary norms cannot necessarily be justified on externality grounds[127] or on the basis of the parties' limited foresight.[128] Finally, the supposed "noneconomic" benefits of mandatory fiduciary duties must be weighed against potential costs, including inhibiting the evolution of new norms, deterring the formation of potentially beneficial relationships, and frustrating equally strong noneconomic values such as humans' need for autonomy.[129]

In short, the "noneconomic" arguments for mandatory fiduciary duties that have been asserted by anticontractarian commentators are vapid and unpersuasive. Simply asserting that noneconomic arguments might justify a different result from "economic" arguments does not eliminate the need to craft noneconomic arguments that make sense.

G. Alternative Legal Responses

Even if the above arguments against enforcing fiduciary duty waivers are sound, they must be embodied in a workable rule. The arguments for nonenforcement, if they are sound at all, apply to so many types of contracts that is difficult to define a logical stopping place for a rule of nonenforcement. This subpart shows that many of the possible rules against enforcing waivers go beyond any policy arguments for nonenforcement.

126. *See* Beasley v. Cadwalader, Wickersham & Taft, No. CL-94-8646 "AJ," 1996 WL 438777, at *7 (Fla. Cir. Ct. July 23, 1996).

127. *See supra* text accompanying note 87.

128. *See generally* Mitchell, *supra* note 6. This type of argument for mandatory fiduciary duties is criticized in *supra* Part II.B.

129. *See* Burrows, *supra* note 68, at 490-97.

1. Judicial Determinations of the "Reasonableness" of Waivers

One possible approach to dealing with contracting problems is to let courts make the decision by enforcing "reasonable" waivers or by adjusting fiduciary duties to a reasonable level even in the absence of an explicit waiver.[130] This raises the question of how well courts can determine when fiduciary duty opt-outs should be enforced.[131] It is a kind of "nirvana" fallacy to assume that judicial review of contract enforceability can avoid the human fallibility that supposedly justifies nonenforcement. In fact, an external decisionmaker probably cannot do a better job than the contracting parties in determining the costs and benefits of waiver in particular circumstances.[132]

First, courts may lack the information necessary to evaluate the costs and benefits of fiduciary duties. This requires a determination of what fiduciaries and beneficiaries would get, and have to give up, under various types of alternative arrangements. Courts must assess the effectiveness of alternative constraints on fiduciary conduct in light of an intimate knowledge of the elements and surrounding circumstances of the particular relationship.[133] For example, the partnership opportunities duty that is appropriate to a particular partnership depends on such factors as the value of the opportunities partners would forgo; the amount of the partners' financial commitment to the relationship; and the existence of other constraints on the partners' discretion, including their respective ownership interests in the firm. Courts also must be able to evaluate the waiver in light of alternative governance structures, including tradeoffs between voting, exit, and fiduciary duty rules. Many judges, however, lack the expertise necessary to make such determinations.

Second, a seemingly bad outcome should not be determinative. The relevant question is how the deal looked at the time the parties made it. Nevertheless, judges who lack the information and sophistication necessary to evaluate the costs and benefits as of when the contract was made may fall

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130. One commentator suggests that fiduciary duties should depend on the extent of the conflict between the fiduciary and the beneficiary, which appears in turn to depend on the extent to which the parties have contracted for alternative constraints on the fiduciary. *See* Dickerson, *Looking Glass*, *supra* note 4, at 958-60. Under this approach, the court would, in effect, supply the waiver it thinks is appropriate based on the other terms of the contract.

131. *See generally* Davis, *supra* note 46.

132. *See* SCHWARTZ, *supra* note 90, at 22-26 (arguing that state should enforce contracts even when they fail because contracts are so context-dependent that courts cannot do better job than parties themselves).

133. Unlike the situation for publicly held firms, courts, like the parties, cannot rely on an informed efficient market price.

back on the easier, and wrong, ex post style of decisionmaking. In other words, they may invalidate waivers that ended up leaving plaintiffs worse off than they would have been without a waiver (that is, under the default fiduciary standard).

Third, judges may suffer both from perverse incentives[134] and from the same sort of cognition defects that supposedly cause contracting parties to make bad deals.[135] Judges who review fiduciary duty waivers suffer from "sample bias," which may cause them to invalidate an excessive number of contracts.[136] In order to obtain a realistic view of which agreements they should not enforce, courts would have to observe the outcomes of the entire universe of fiduciary duty waivers. With such observations, courts would see that "bad" cases, in which outcomes are highly favorable for fiduciaries, are simply part of a normal distribution. In other words, courts would be seeing ex post the distribution of results that the parties expected ex ante. But courts see only the waiver cases in which beneficiaries are complaining because the deal turned out well for the fiduciary — as when the fiduciary turned out to have particularly good outside investment opportunities. This lopsided view suggests that waivers systematically favor fiduciaries — a view that is conducive to invalidating the agreements. A judge also may tend to assume that future cases will resemble the case it is deciding because of the sort of "availability" and "representativeness" problems identified below as reasons for not enforcing waivers.[137] As a result, a court may be more likely to render a decision that will deter such bad conduct and may fashion a rule that will guide later cases to similar results.

2. *Unconscionability*

Courts could refuse to enforce fiduciary duty waivers as procedurally or substantively unconscionable.[138] Procedural unconscionability would require fiduciaries to refrain from undesirable conduct such as physical duress and would not force courts to review contract terms.[139] This would

134. *See supra* text accompanying note 100.

135. *See supra* Part II.C.

136. *See* Fischel & Bradley, *supra* note 46, at 265 (discussing problem in context of judicial review of corporate management misconduct).

137. *See supra* text accompanying notes 61-67.

138. *See* Hynes, *supra* note 3, at 45-46, 52-53. For an excellent analysis of unconscionability, see generally Richard Craswell, *Property Rules and Liability Rules in Unconscionability and Related Doctrines*, 60 U. CHI. L. REV. 1 (1993).

139. *See* Craswell, *supra* note 138, at 18 (characterizing procedural unconscionability

rarely be a problem for fiduciary duty waivers.[140] Substantive unconscionability focuses on the egregious unfairness of the terms of the contract. A detailed application of unconscionability standards to fiduciary duty waivers is beyond the scope of this Article. The important point for present purposes is that an unconscionability standard has the virtue of integrating enforceability of fiduciary duty waivers into the general law of contracts. For this reason, unconscionability may be too narrow a basis of invalidation to satisfy anticontractarians.[141]

3. *The "Safe" Partnership*

Another possible limitation on waiver would be to restrict enforcement to firms whose members are least likely to make bad contracts. One writer argues that general partnerships must offer a safe and "familiar" landscape for small, more informal firms of relatively unsophisticated people for whom having to deal with opt-outs would be particularly costly.[142] This makes some superficial sense because the general partnership is the default business entity that embraces the least sophisticated firms. Somewhat inconsistently, the same author notes that the partnership form has been used by a "dazzling array of relationships"[143] and that the variability of partnership has frightened some business people into the less variable corporate form.[144] Perhaps in the future only the more vulnerable "default" relationships will be channeled into the partnership form while other busi-

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as "property" rule that permits parties rather than external decisionmakers to make ultimate decisions about disposition of property).

140. *See* Degenhardt v. Dillon Co., 669 A.2d 946 (Pa. 1996). In *Degenhardt*, the court upheld a partner's assignment to a copartner when the assignor had an opportunity to consult with legal counsel before entering into the contract, assignee's agents did not subject individual partner to physical force or unlawful threats, assignor considered the terms for four days before signing it, and assignor was induced to sign by the expectation of immediate economic gain. *Id.* at 950-52.

141. *See* Weidner, *supra* note 4, at 95 n.65 (asserting that unconscionability is appropriate only for one-shot contracts and not for cooperative relationships). Weidner curiously supports this assertion by citing the default rule of voidability of interested transactions that is irrelevant to the issue of whether waivers of the default rule should be enforced. Another writer suggests that a process-oriented unconscionability rule might trigger preformation fiduciary duties and make it difficult to determine whether beneficiaries have given enforceable consent to self-dealing. *See* Vestal, *Response*, *supra* note 4, at 73-74. But a duty to refrain from duress or force is quite different from a preformation fiduciary duty.

142. *See* Weidner, *supra* note 4, at 107.

143. *Id.* at 83.

144. *Id.* at 102 n.89 (citing Joseph Bankman, *The Structure of Silicon Valley Start-Ups*, 41 UCLA L. REV. 1737, 1751-52 (1994)).

ness forms will become havens of variability and flexibility. As discussed further below,[145] the idea of the "safe" partnership can be seen as generally consistent with the contractarian approach, although it may unduly restrict contracting flexibility.

Another commentator proposes to permit opt-outs in specially designated partnerships.[146] This proposal would let investors choose whether or not to invest in a protected firm. It is unclear, however, why "irrational" bargainers should be deemed to be able to make a rational choice of business form if they cannot rationally make other types of deals. At best, this proposal would mitigate irrationality problems by focusing bargainers' attention on the risk they face. But it is not clear that this is necessary because any fiduciary duty waiver is a notorious departure from strong default fiduciary duties.[147]

Finally, if the partnership form, or at least some partnerships, should be "safe" for the irrational, why should fiduciary duties be the only mandatory rules? Bargainers' cognitive and bargaining defects also could justify mandatory rules concerning exit, manager compensation, and many other contract terms.

4. The "Eligible Investor" Approach

A fourth approach to nonenforcement of waivers would focus on types of bargainers rather than on types of contracts or firms. Perhaps legislators should adopt something like the "sophisticated investor" rule that is used for determining the availability of the private offering exemption under the Securities Act of 1933.[148] Under such a proposal, only certain investors could choose not to be protected by fiduciary duties, just as only certain investors can choose not to be protected by the securities laws. But this sort of bright-line test can be adopted only by regulators or legislators and not by courts on a case-by-case basis. Notably, no statute has gone this far. Nor is it clear where the line should be drawn for fiduciary duty waivers — for example, whether minimum wealth requirements should be enough or whether the rule should be based on educational level or business experience.

145. *See infra* Part III.E.3.

146. *See* Vestal, *Error*, *supra* note 4, at 578.

147. *See supra* note 52.

148. *See* Securities and Exchange Commission Regulation D, 17 C.F.R. §§ 230.501-230.508 (1996).

5. *Broad Waivers and "No-Duty" Clauses*

A fifth possible approach to nonenforcement would be to focus on the scope of the waiver, as do the recent uniform laws on partnerships and limited liability companies.[149] The basis of this limitation is that investors have a particularly hard time foreseeing and evaluating the impact of broad waivers.[150] However, as already discussed,[151] the investor irrationality argument, if it applies at all, applies to any contract that will operate into the future, including a relatively narrow waiver.

Even if broad waivers are enforced, perhaps courts should not enforce clauses under which a purported fiduciary has no duty at all to his beneficiary. One commentator insists that nonenforcement of such no-duty partnerships would involve little, if any, cost in terms of barring efficient contracts.[152] But it is unclear why even such an extreme waiver should present a particular problem. The parties clearly *can* enter into relationships, as by taking assignments of partnership interests,[153] that entail no fiduciary duties or indeed any of the management or information rights associated with partnership. These relationships may be sensible. For one thing, the costs of going to court over whether a partner has been unduly selfish or unfair may be very high. For another, it may be more cost-effective to substitute for fiduciary duties other constraints on managers' conduct, such as partners' power to exit the relationship at will through buyout or dissolution.[154] For example, if the firm is capitalized on a deal-by-deal basis, the nonmanaging investors can leave at any time if they believe their investment is not paying off.[155] Even if some no-duty relationships are inefficient, the category may be difficult to define. For example, it may not be clear whether a prohibition on total waivers applies to a *near*-elimination of duties or to an elimination of most or all remedies.

Across-the-board waivers do raise a potential *interpretation* problem.[156] For example, perhaps it should make a difference whether the parties

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149. *See* RUPA § 103(b); ULLCA § 103(b); *see also infra* Part III.E.

150. *See supra* text accompanying note 73.

151. *See supra* text accompanying note 73.

152. *See* Weidner, *supra* note 4, at 101-03.

153. *See infra* Part III.E.2.

154. *See supra* Part I.C.

155. *See generally* Burg v. Horn, 380 F.2d 897 (2d Cir. 1967) (considering case involving this fact situation).

156. *See* 2 BROMBERG & RIBSTEIN, *supra* note 22, § 6.07, at 6:91-6:92 (noting that "a court may interpret an across-the-board waiver strictly and apply even a clear waiver cautiously").

contracted for a nonfiduciary relationship or attempted to opt out of all fiduciary duties in a partnership. Because the parties *can* enter into relationships that do not entail default fiduciary duties, their decision to form a *partnership* arguably indicates that they intended to contract for some fiduciary duties notwithstanding contrary language in the partnership agreement. But courts can deal with this sort of question, as they have with other interpretation issues,[157] on a case-by-case basis.

III. Legal Support for Enforcement of Contracts

Against the significant support for contracting out of fiduciary duties, the anticontractarians have made conclusory arguments that the law does not permit such waivers while citing few, if any, supporting cases. The Reporter to RUPA, responding to criticism of RUPA's limitations on waivers, cites no cases that support these limitations.[158] Another commentator cites three such cases, none of which involve a fiduciary duty waiver.[159]

This Part undertakes the careful review of the case law that is lacking in the anticontractarian commentary. It shows that, far from being the position of wild-eyed "contractarian extremists,"[160] this contractual view of fiduciary duties is, in fact, nearly universally accepted by state statutes and courts. In other words, those who seek to change the law through RUPA and the ULLCA are the "extremists." To reach this conclusion, this Article relies on the research for *Bromberg & Ribstein on Partnership*. This treatise includes at least all partnership cases cited under "Partnership" keynotes in the West Reporter system after 1965, plus a significant number of post-1965 cases that are either not in the West system or that do not have Partnership keynotes. It also includes the substantial research reflected in the predecessor works, *Crane on Partnership* and *Crane & Bromberg on Partnership*, for the period prior to 1965. This is the most exhaustive review of recent partnership case law of which I am aware. Although it does not purport to reach all relevant cases, the important point is that the sample is not only large but also unbiased in that there is no reason to expect that excluded cases would be particularly likely to include cases in which contracts were not enforced. Although the discussion of specific

157. *See infra* Part III.B.

158. *See* Weidner, *supra* note 4, at 91-92.

159. *See* Vestal, *Response*, *supra* note 4, at 59 n.17 (citing, "e.g.," *Appletree*, discussed above; *Labovitz v. Dolan*, discussed below; and third case, *Saballus v. Timke*, which applies default disclosure duty to managing partner, but which does not involve purported waiver of that duty).

160. *See* Weidner, *supra* note 4, at 97.

cases is selective, it does not omit any cases in the database that might support the anticontractarian position.

Subparts A and B below discuss the most important issues of the enforceability of fiduciary duty opt-outs and analogous open-ended contract terms. Subpart C shows that courts have enforced contracts as written rather than implicitly invalidating them through restrictive interpretation. Subpart D carries the discussion into statutory law by analyzing a Delaware statute that clarifies the enforcement of fiduciary duty waivers. Subpart E shows that courts and legislatures have respected not only direct waivers, but also contracts that have the same ultimate effect by determining the general rules that apply to the parties' relationship. Finally, subpart F shows the extent to which the recent uniform law proposals depart from the overwhelming case and statutory law that preceded them.

A. Cases Enforcing Fiduciary Duty Waivers

This subpart discusses cases involving waivers of fiduciary duties that are entered into in advance of the conduct related to the waiver. The first five sections discuss cases relating to particular fiduciary duties. They show that case law overwhelmingly supports enforcement of fiduciary duty waivers. This is consistent with Section 21 of the UPA, the only provision that refers to a partner as a "fiduciary,"[161] which provides that:

> Every partner must account to the partnership for any benefit, and hold as trustee for it any profits derived by him *without the consent of the other partners* from any transaction connected with the formation, conduct, or liquidation of the partnership or from any use by him of its property.[162]

1. Self-Dealing

Partners can contract around the fiduciary's central obligation to act unselfishly in dealing with the partnership.[163] Such waivers may, among other things, provide important flexibility to engage in transactions that will benefit the partnership because the partners themselves are the best sources for the partnership's labor and materials.[164] Courts have permitted self-

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161. The title of UPA Section 21 is "Partner Accountable as a Fiduciary."

162. UPA § 21 (emphasis added).

163. This approach is consistent with analogous authority enforcing contractual authorization of self-dealing by trustees. *See* Langbein, *supra* note 8, at 659 (noting and citing authority for proposition that "the duty of loyalty is default law that yields to contrary terms of the trust deal").

164. *See supra* Part I.D. This is recognized explicitly in the UPA and RUPA provisions that one may be a partner even if one also deals with the partnership in another capac-

dealing even under partnership agreement provisions that only implicitly waived the duty. *Riviera Congress Associates v. Yassky*[165] held that a statement of purpose in a limited partnership prospectus precluded summary judgment for the plaintiff on the claim that the partners breached their fiduciary duty by leasing the partnership motel to their own companies.[166] This case shows that partners can waive the duty not to engage in self-dealing even in a limited partnership, in which the separation of ownership and control makes the duty particularly important. Similarly, *Murphy v. Gutfreund*[167] allowed partners to reap substantial profits in a dissolution that was within their power under the partnership agreement.[168] *Adler v. William Blair & Co.*[169] held that the general partner in a limited partnership could invest in property consistent with disclosures in the partnership agreement that the purpose of the partnership was to invest for capital appreciation and not primarily for tax losses, that the tax laws might be changed, and that the general partners could have conflicts of interest.[170] And *Covalt v. High*[171] held, again without an explicit waiver, that one of two partners who was an officer and a shareholder of a partnership's corporate tenant did not breach a fiduciary duty by refusing to raise the rent when the partners were aware of the potential conflict from the beginning of the partnership and both were associated with the corporation.[172]

2. *Partners' Outside Dealings: Competition and Opportunities*

Courts have enforced agreements that allow partners to engage in outside dealings. One of the most important such cases is *Singer v. Singer*,[173]

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ity, such as debtor-creditor or employee-employer. *See* UPA § 7(4); RUPA § 202(c)(3). It is also implicit in the RUPA provision that "[a] partner may lend money to and transact other business with the partnership, and as to each loan or transaction the rights and obligations of the partner are the same as those of a person who is not a partner, subject to other applicable law." *Id.* § 404(f).

165. 223 N.E.2d 876 (N.Y. 1966).

166. *See* Hynes, *supra* note 3, at 42-43 (discussing *Yassky*).

167. 583 F. Supp. 957 (S.D.N.Y. 1984).

168. Murphy v. Gutfreund, 583 F. Supp. 957, 971 (S.D.N.Y. 1984).

169. 613 N.E.2d 1264 (Ill. App. Ct. 1993).

170. Notably, this case distinguished and limited the *Labovitz* case, showcased in the comments to RUPA as a leading case for the anticontractarian position. *See infra* text accompanying notes 212-17 (discussing *Labovitz*).

171. 675 P.2d 999 (N.M. App. Ct. 1983).

172. Covalt v. High, 675 P.2d 999, 1000 (N.M. Ct. App. 1983).

173. 634 P.2d 766 (Okla. Ct. App. 1981). This case is discussed in Hynes, *supra* note 3, at 41-42. For another important and recent case supporting fiduciary duty waivers in

which permitted a partner in an oil production partnership to purchase land within the area of the partnership's interest under the following provision:

> Each partner shall be free to enter into business and other transactions for his or her own separate individual account, even though such business or other transaction may be in conflict with and/or competition with the business of the partnership. Neither the partnership nor any individual member of this partnership shall be entitled to claim or receive any part of or interest in such transactions, it being the intention and agreement that any partner will be free to deal on his or her own account to the same extent and with the same force and effect as if he or she were not and never had been members of this partnership.[174]

Similarly, *Singer v. Scher*[175] enforced an oral agreement that permitted law partners to keep profits from investment opportunities derived from clients, including stock options.[176] And in *Dremco, Inc. v. South Chapel Hill Gardens, Inc.*,[177] the court held that a joint venturer (which the court treated as a partner) had no fiduciary duty except with respect to the specific joint venture property, and therefore could pursue other ventures under an agreement that both limited the scope of the venture to the purchase and development of specific property and permitted the venturers to engage in other opportunities.[178]

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partnerships, see *U.S. West, Inc. v. Time Warner Inc.*, 1996 WL 307445 (Del. Ch. June 6, 1996) (interpreting noncompetition provision in joint venture agreement as allowing joint venturer to buy company, although this would place it in competition with plaintiff in way that had not been contemplated at time of agreement, and holding that purchase would not violate venturer's fiduciary duties). Chancellor Allen stated: "Certainly partnerships are amenable to greater freedom contractually to shape the set of legal relationships that constitute the partnership than are corporations, and this freedom may include clear contracting with respect to fiduciary duties." *Id.* at *22.

174. Singer v. Singer, 634 P.2d 766, 768 (Okla. Ct. App. 1981).

175. 761 F. Supp. 145 (D.D.C. 1991).

176. Singer v. Scher, 761 F. Supp. 145, 150 (D.D.C. 1991).

177. 654 N.E.2d 501 (Ill. App. Ct. 1995).

178. Dremco, Inc. v. South Chapel Hill Gardens, Inc., 654 N.E.2d 501, 505 (Ill. App. Ct. 1995). The agreement provided in part:

> [N]othing herein contained shall be construed to constitute any Joint Venturer the agent of any other Joint Venturer or to limit in any manner any Joint Venturer in carrying on of its own respective business or activities . . . . Any Joint Venturer may engage in and/or possess any interest in other business and real estate ventures of any nature or description, independently or with others, including, but not limited to, the ownership, management, operation, financing, leasing, syndication, brokerage, and development of real property; and neither the Joint Venture nor any Joint Venturer, by reason of this Agreement or by reason of holding an interest in this Joint Venture, shall have any right or

Several cases have reached similar results even in the absence of explicit fiduciary duty waivers by holding that partners could engage in opportunities on their own behalf that were outside the scope of the partnership defined in the partnership agreement.[179] Courts have done so even when the opportunity involved land adjacent to the specific property the partnership was created to develop.[180]

The agreement may limit the venture in time as well as in geographic scope. Courts have interpreted relationships as involving sequences of separate ventures, so that partners could acquire related ventures.[181] Other cases have held that a partner's fiduciary duty regarding opportunities did not extend beyond dissolution of the venture.[182] These cases should be contrasted with *Meinhard v. Salmon*,[183] which held that a nonmanaging partner was entitled to share in a deal offered to the partnership by the party for whom the partnership had managed the property.[184] In contrast to Justice Cardozo's famous language suggesting an absolute duty,[185] the

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> interest in or to any such independent venture or the income or profits derived therefrom.

Id.

179. *See* Mathis v. Meyeres, 574 P.2d 447, 449 (Alaska 1978); Lipinski v. Lipinski, 35 N.W.2d 708, 713 (Minn. 1949); Smith v. Bolin, 271 S.W.2d 93, 96-97 (Tex. 1954); Warner v. Winn, 197 S.W.2d 338, 342 (Tex. 1946); Johnson v. Buck, 540 S.W.2d 393, 399 (Tex. App. 1976, writ ref'd n.r.e.); 2 BROMBERG & RIBSTEIN, *supra* note 22, § 6.07, at 6:79-:80 n.44-46; *see also* Deauville Corp. v. Federated Dep't Stores, Inc., 756 F.2d 1183, 1194 (5th Cir. 1985) (holding that joint venturers do not owe fiduciary duty beyond express terms of partnership agreement); *cf.* Burg v. Horn, 380 F.2d 897, 900 n.1 (2d Cir. 1967) (permitting manager of real estate investment partnership to take some opportunities for himself when firm's minimal capitalization indicated limited scope of venture); Huffington v. Upchurch, 532 S.W.2d 576, 579-80 (Tex. 1976) (holding that managing partner could not take for own benefit opportunity that fell within partnership business as described in partnership agreement).

180. *See Mathis*, 574 P.2d at 449; *Lipinski*, 35 N.W.2d at 713.

181. *See* Menos v. Hodges, 499 S.W.2d 427, 431 (Mo. 1973) (permitting partner to buy nursing home for himself when partnership had acquired series of nursing homes). In *Burg*, 380 F.2d at 900 & n.1, the firm's minimal capitalization suggests that it was actually a series of related ventures funded on a deal-by-deal basis.

182. Cude v. Couch, 588 S.W.2d 554, 556 (Tenn. 1979), *noted in* 11 MEM. ST. U.L. REV. 143, 144 (1980); Mathis v. Cactus Drilling Corp., 430 S.W.2d 78, 83-84 (Tex. App. 1968, writ ref'd n.r.e.) (holding that partner who worked with copartner on accommodation for third party in hope of receiving additional business from third party was not entitled to deal offered to copartner after dissolution).

183. 164 N.E. 545 (N.Y. 1928).

184. Meinhard v. Salmon, 164 N.E. 545, 548 (N.Y. 1928).

185. *See supra* text accompanying note 15.

case actually turns on the parties' expectations. In particular, the parties' twenty-year relationship arguably made the scope of this venture broader than that of the usual joint venture, and the fact that the disputed opportunity included the property that the partnership had managed supported bringing the new opportunity into the scope of the partnership. Thus, Justice Cardozo himself acknowledged that he would bend his "uncompromising rigidity" in the face of different facts:

> If Salmon had received from Gerry a proposition to lease a building at a location far removed, he might have held for himself the privilege thus acquired, or so we shall assume. Here the subject-matter of the new lease was an extension and enlargement of the subject-matter of the old one.[186]

3. *Compensation*

Courts enforce contracts that waive the default partnership rule against compensating partners for acting in the course of the partnership business.[187] To be sure, an agreement to pay specific compensation differs from a waiver of liability for future conduct. But permitting a partner to pay himself unspecified amounts in the future is very much like compensating the partner by allowing him to engage in other forms of self-interested conduct.[188] Thus, a case holding that a compensation provision in the partnership agreement prevents such compensation from being a breach of fiduciary duty[189] could apply equally to a fiduciary duty waiver.

4. *The Duty to Disclose*

Unlike the general fiduciary duty under Section 21 of the UPA, the duty to disclose under Section 20 of the UPA is not explicitly subject to the partners' contrary agreement.[190] One might argue that disclosure is so basic

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186. *Meinhard*, 164 N.E. at 548. Even under the facts in the case, Judge Andrews would have held that this was not a partnership opportunity. *Id.* at 552 (Andrews, J., dissenting).

187. *See* 2 BROMBERG & RIBSTEIN, *supra* note 22, § 6.07, at 6:91 n.92.

188. *See* Gompers & Lerner, *supra* note 37, at 471 (characterizing compensation of general partners in venture capital partnerships as consisting of both monetary compensation and ability to "receive private benefits from certain activities," and discussing why managers may seek to be compensated through reduced restrictions on their private gains rather than by higher percentage of firm's income).

189. *See* Wilson v. Button, 404 F.2d 309, 310 (5th Cir. 1968) (finding that partner's payment to himself of reasonable salary was not breach of fiduciary duty because partners had agreed to salary arrangement).

190. *Compare* UPA § 20, *with id.* § 21.

a right that the parties should not be able easily to waive it. There is some dicta to the effect that disclosure duties cannot be waived. In *Appletree Square I Limited Partnership v. Investmark, Inc.*,[191] the court held that a partnership agreement requiring the general partners to "provide the partners with all information that may reasonably be requested" did not protect the partners from liability for failure to disclose asbestos contamination in the partnership's building.[192] The court reasoned that a contract provision that relieved the defendant of the duty to disclose was against public policy in this setting because its major purpose was to shield wrongdoers from liability.[193] Notably, however, the agreement did not waive the defendant's disclosure duty, but rather stated an affirmative obligation to disclose.[194]

Another case with dictum supporting mandatory disclosure duties is *Marsh v. Gentry*,[195] in which the defendant-partner argued that his copartner's awareness of a custom of secret bidding by co-owners of horses authorized the defendant to withhold the information that he had secretly bid for and purchased horses owned by the partnership.[196] The court held that no such practice was established, but also stated that any such practice could not override the defendant's legal obligation to disclose.[197]

No court has *held* that an agreement waiving disclosure duties is unenforceable. To the contrary, there is explicit authority supporting enforcement of such an agreement. *Exxon Corp. v. Burglin*[198] held that a limited partnership agreement could restrict limited partners' access to, and general partners' duty to disclose, confidential information regarding oil leases.[199] The court reasoned that the agreement permitted limited partners to compete with the partnership, that the limited partners were highly

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191. 494 N.W.2d 889, 893 (Minn. Ct. App. 1993).

192. Appletree Square I Ltd. Partnership v. Investmark, Inc., 494 N.W.2d 889, 893 (Minn. Ct. App. 1993).

193. *Id.*

194. *Id.* The case is perhaps more remarkable in expanding the default duty under the UPA to "render *on demand* true and full information of all things affecting the partnership." UPA § 20 (emphasis added). This can be explained by the fact that the defendants were the builders and sellers of the building. Thus, the case holds only that a builder or a seller cannot be exonerated from a common-law duty to disclose a building's hazard to a buyer merely because the seller also happens to hold an interest in the purchasing partnership and the partnership agreement happens to provide for an obligation to disclose information when asked. *Appletree Square I Ltd. Partnership*, 494 N.W.2d at 892.

195. 642 S.W.2d 574 (Ky. 1982).

196. Marsh v. Gentry, 642 S.W.2d 574, 576 (Ky. 1982).

197. *Id.*

198. 4 F.3d 1294 (5th Cir. 1993).

199. Exxon Corp. v. Burglin, 4 F.3d 1294, 1298-99 (5th Cir. 1993).

sophisticated, represented by counsel, compensated for relinquishing the disclosure right, and could have obtained an independent evaluation or rejected the offer.[200] Although the case leaves open the possibility that a broader waiver of the disclosure duty, or one by less sophisticated partners, might not be enforced, it clearly recognizes the principle that the partners may contract regarding disclosure.

5. *Remedies*

The partners may waive not only fiduciary duties, but also the traditional means of enforcing such duties — the right to an accounting under the UPA.[201] *Lenz v. Associated Inns & Restaurants Co. of America*[202] enforced an agreement that explicitly waived partners' rights to an accounting.[203] The court relied on authorities, including *Singer v. Singer*,[204] that enforced waivers of substantive duties.[205] Other courts have held that the partnership agreement may provide a substitute for the statutory accounting remedy,[206] and that an agreement may provide for expulsion of a partner who contests a general partner's management decision.[207] Courts also have enforced quite generally and broadly arbitration provisions in partnership agreements.[208] This type of agreement has been endorsed even by anti-contractarians, usually on the basis that it substitutes rather than eliminates remedies.[209] But this is not essentially different from substituting other constraints on fiduciaries for fiduciary duties.

B. *Interpretation Issues*

In order to evaluate supposed case law support for the anticontractarians' position, it is necessary to analyze cases that sometimes involve strong

200. *Id.*

201. *See* UPA § 28.

202. 833 F. Supp. 362 (S.D.N.Y. 1993).

203. Lenz v. Associated Inns & Restaurants Co. of America, 833 F. Supp. 362, 383-84 (S.D.N.Y. 1993)

204. 634 P.2d 766 (Okla. Ct. App. 1981); *see supra* text accompanying note 173.

205. *Lenz*, 833 F. Supp. at 383-84.

206. Raymond v. Brimberg, 473 N.Y.S.2d 437, 439 (1984).

207. McLendon v. McLendon, 862 S.W.2d 662, 675-77 (Tex. App. 1993, reh'g writ overuled). The court noted that the provision did not authorize self-dealing in violation of "public policy" or provide for reallocation of expelled partner's interest solely to managers, although it is unclear under what circumstances the court would have refused to enforce the expulsion.

208. *See* 2 BROMBERG & RIBSTEIN, *supra* note 22, § 6.08, at 6:119-6:122.

209. *See* Coffee, *No Exit*, *supra* note 6, at 953-74; Thompson, *supra* note 6, at 395; Weidner, *supra* note 4, at 94.

language against waivability. This subpart shows that, when the cases are so analyzed, they do not actually *hold* that waivers are unenforceable. Instead, they either did not involve waivers at all or involved conduct that fell outside the waiver. Although judges might use the *language* of mandatory rules, this language is not law. For example, a court's opinion on the scope of fiduciary duties in a case in which fiduciary duties were *not* waived has no precedential value in a case in which they *were*. The traditional legal approach to dicta is amply justified because judges often do not intend dicta to be taken as law[210] and because judges' discretion is more constrained in making decisions than in stating dicta.[211] Section 3 theorizes about a potential third category of cases in which the courts might use "good faith" to end-run fiduciary duty waivers.

1. *Fiduciary Duties in the Exercise of Power Under Agreement*

Several cases hold that partners had fiduciary duties despite broad delegations of power to partners under agreements that did not contain fiduciary duty waivers. Apart from dicta in some of these cases stating that fiduciary duties may not be waived, most of the cases are unremarkable because an agreement that delegates power over a beneficiary's property is precisely the situation in which one would expect default fiduciary duties to apply. Thus, in *Labovitz v. Dolan*,[212] the lone case for nonwaivability cited in the Official Comment to RUPA Section 103, the court held that a provision in the partnership agreement giving the general partner discretion over distributions did not authorize him to breach his fiduciary duty by withholding distributions in order to squeeze out the limited partners.[213] Because the agreement did not include a fiduciary duty waiver, the case

210. *See supra* note 119 and accompanying text.

211. Courts may use the sort of *language* that will win fame by being cited in later decisions. *See* RICHARD A. POSNER, CARDOZO: A STUDY IN REPUTATION 132 (1990) (contending that Judge Cardozo sought to increase his reputation with legal academics); Richard A. Epstein, *The Independence of Judges: The Uses and Limitations of Public Choice Theory*, 1990 BYU L. REV. 827, 837. *See generally* BRUCE H. KOBAYASHI & JOHN R. LOTT, JR., JUDICIAL REPUTATION AND THE EFFICIENCY OF THE COMMON LAW (1994). Or courts may simply wish to express their opinions, like other observers and voters. *See* RICHARD A. POSNER, OVERCOMING LAW 109-44 (1995). But courts' *decisions* are constrained by competition from arbitrators and other dispute resolvers as well as by the possibility of reversal by appellate courts. *See* Paul H. Rubin & Joel L. Schrag, *Judicial Hierarchies and the Rule-Individual Tradeoff* (Feb. 6, 1995) (unpublished manuscript, on file with author). On this analysis, judges' decisions should be taken more seriously than their language.

212. 545 N.E.2d 304 (Ill. App. Ct. 1989).

213. Labovitz v. Dolan, 545 N.E.2d 304, 313 (Ill. App. Ct. 1989).

holds only that generally empowering a partner to engage in a particular activity does authorize the partner to squeeze out the other partners.[214] Indeed, the dictum is not much stronger. The court says that "the fiduciary duty exists concurrently with the obligations set forth in the partnership agreement whether or not expressed therein."[215] This means only that default fiduciary duties exist even if they are not stated in the agreement. The court also said that partners "are not free to destroy [the partnership's] fiduciary character."[216] This is different from saying that the partners may not contract to enforce fiduciary obligations other than through legal fiduciary duties and remedies. Consistent with this analysis, *Labovitz* was later distinguished as a squeezeout case by appellate opinions in the same state that upheld partners' self-interested actions in accordance with authorizations in the partnership agreements.[217]

Other cases that, like *Labovitz*, include strong dicta about fiduciary duties hold only that a partnership agreement's delegation of power does not, *in the absence of a waiver*, authorize the empowered partners to breach their default fiduciary duties. *Palmisano v. Mascaro*[218] held that a partner was subject to fiduciary duties under an agreement which provided that the partner would not be liable for acts within the scope of his authority unless the acts were misfeasance or malfeasance; authorized him to sell partnership property on such terms as he in his sole and uncontrolled discretion deemed necessary, advisable, or proper; *and* required the partner to act as a fiduciary and prudent administrator.[219] Although the court stated that the parties could not contract around fiduciary duties provided for in the Louisiana statute, this statement was only dictum in the absence of such a contract. *Knopke v. Knopke*[220] held that the general partner had a fiduciary duty to deal prudently and honestly with the partnership and other partners

214. *See* Deborah A. DeMott, *Fiduciary Preludes: Likely Issues for LLCs*, 66 U. COLO. L. REV. 1043, 1045-49 (1995) (suggesting that courts will apply good faith limit on fiduciaries' exercise of discretion under general discretionary power like that in *Labovitz*). However, as indicated in the text, it is not necessary to resort to a good faith analysis. The conduct is clearly covered by a default fiduciary duty in the absence of a waiver.

215. *Labovitz*, 545 N.E.2d at 313.

216. *Id.*

217. *See* Dremco, Inc. v. South Chapel Hill Gardens, Inc., 654 N.E.2d 501 (Ill. App. Ct. 1995); Adler v. William Blair & Co., 613 N.E.2d 1264 (Ill. App. Ct. 1993); *see also supra* notes 169-70 (discussing *Adler*); *supra* notes 177-78 (discussing *Dremco*). Justice Scariano, the author of *Labovitz*, concurred in *Dremco*.

218. 611 So. 2d 632 (La. Ct. App. 1992).

219. Palmisano v. Mascaro, 611 So. 2d 632, 644 (La. Ct. App. 1992).

220. 837 S.W.2d 907 (Mo. Ct. App. 1992).

and, within the bounds of discretion, to invest surplus partnership funds to make a reasonable return under a limited partnership agreement that gave general partners in a limited partnership the "unqualified authority" to make all decisions relating to the financial affairs of the partnership.[221] Again, the case involved no explicit fiduciary duty waiver. *Jerman v. O'Leary*[222] held that a general partner breached his fiduciary duty by acquiring property at a below-market price without full disclosure although the partnership agreement authorized the partner to acquire property from the partnership.[223] Once again, the agreement did not waive the partners' fiduciary duties.

The most extensive opinion in the group, *Konover Development Corp. v. Zeller*[224] held that, although the limited partnership agreement permitted the general partner to withdraw and demand payment for development expenses if it decided in its sole discretion that the project was not feasible, it was error to instruct the jury that the general partner's decision would be upheld if reasonable.[225] The court reasoned that the partner's decision was subject to a fiduciary duty of fairness to the limited partner that was shaped by several factors, including the limited partner's sophistication, the relative bargaining power among the parties, disclosure, and the adequacy of consideration.[226] The court noted the general partner's need for flexibility and the risk that the limited partner could hold the general partner "hostage" in the partnership.[227] Like the cases discussed above, the case did not involve an explicit fiduciary duty waiver. Moreover, rather than saying that fiduciary duties were absolute, the court emphasized the flexibility of fiduciary duties and the need to adapt them to the particular circumstances of the case.[228]

The only questionable decisions in this category are those in which a court might have inferred, but did not infer, a fiduciary duty waiver from the circumstances of the agreement, as other cases have done.[229] In particular, *Starr v. Fordham*[230] held that law partners with the power to determine

221. Knopke v. Knopke, 837 S.W.2d 907, 915 (Mo. Ct. App. 1992).

222. 701 P.2d 1205 (Ariz. Ct. App. 1985).

223. Jerman v. O'Leary, 701 P.2d 1205, 1209-10 (Ariz. Ct. App. 1985).

224. 635 A.2d 798 (Conn. 1994).

225. Konover Dev. Corp. v. Zeller, 635 A.2d 798, 805 (Conn. 1994).

226. *Id.* at 807-09.

227. *Id.* at 809.

228. *Id.* at 806.

229. *See supra* Part III.A.1.

230. 648 N.E.2d 1261 (Mass. 1995).

the payout to a withdrawing partner under a partnership agreement had to prove that the price was fair.[231] Unlike the other decisions in this group, the plaintiff in *Starr* knew that the managing partners would have a conflict of interest in making the precise compensation decision that the agreement empowered them to make.[232] Thus, the court might have inferred plaintiff's consent to a conflict that was, in effect, "embedded" in the relationship to which he had explicitly consented.[233] To be sure, the plaintiff might have expected fiduciary duties to apply to the managers' determination of his exit compensation.[234] Nevertheless, the parties might explicitly have agreed to forgo costly enforcement of fiduciary duties.[235] In any event, the court probably was persuaded not to imply a waiver because the managing partners had misrepresented to the plaintiff how they planned to determine his compensation.[236]

2. *The Limits of Fiduciary Duty Waivers*

This section discusses interpretations of agreements that include fiduciary duty waivers, but which courts have interpreted as not exonerating the disputed conduct. Although the cases involve attempted waiver, they are not authority against enforcement of fiduciary duty waivers. Rather, the cases merely involve judicial determinations that the conduct was not within the waiver and therefore was subject to default fiduciary duties. For example, a provision that permits partners to engage in outside business does not authorize the partners to use this power to, in effect, steal the

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231. Starr v. Fordham, 648 N.E.2d 1261, 1265 (Mass. 1995). For a similar case, see *Smith v. Brown & Jones*, 633 N.Y.S.2d 436 (Sup. Ct. 1995) (relying on *Starr* and holding that partners engaged in self-dealing by setting artificially low buyout price).

232. *Starr*, 648 N.E.2d at 1264.

233. *See* Langbein, *supra* note 8, at 665-66 (arguing that conflicts that are embedded in nature of transaction should not be rigidly enforced). For a case in which a court did not enforce such an "embedded" conflict, see *Covalt v. High*, 675 P.2d 999 (N.M. Ct. App. 1983). *See also supra* notes 171-72 and accompanying text (discussing *Covalt*).

234. The plaintiff might have been foolhardy to trust the managers in this situation because their selfishness would be unconstrained by other considerations, such as a desire to retain the plaintiff's services. This contrasts with the "embedded" conflicts discussed by Langbein in which the trustee's self-dealing may at least be in the settlor's interests, which was arguably the case with Mark Rothko's executors' disposition of Rothko's trust property. *See* Langbein, *supra* note 8, at 665-66 (discussing *In re* Rothko, 372 N.E.2d 291 (N.Y. 1977).

235. *See supra* Part I.D.

236. Starr v. Fordham, 648 N.E.2d 1261, 1265 (Mass. 1995). It is not clear that the plaintiff was entitled to rely on this representation in light of the unrestricted delegation of power in the partnership agreement.

partnership. Thus, *Wartski v. Bedford*[237] held that a partner's purchase of a related company critical to the partnership for a total of $10 was not within a general clause in the partnership agreement authorizing the partners to compete.[238] Accordingly, the court's statement that the parties could not wholly negate their fiduciary duties[239] was only dictum. Similarly, *Lyall v. Grayco Builders, Inc.*[240] held that a partnership agreement that authorized a partner to work on other projects independently did not give him the right to deprive a copartner of his partnership interest by essentially undercutting the partnership's business.[241] Nor does a partnership agreement that authorizes competition extend to the use of partnership property or information or to misrepresentations. Thus, *Tri-Growth Centre City, Ltd. v. Silldorf*,

237. 926 F.2d 11 (1st Cir. 1991).

238. Wartski v. Bedford, 926 F.2d 11, 19 (1st Cir. 1991). The clause provided: "General partners shall not be prevented from engaging in other activities for profit, whether in research and development or otherwise, and whether or not competitive with the business of the partnership." *Id.* at 20.

239. *Id.* at 19-20.

240. 584 N.Y.S.2d 465 (Sup. Ct. 1992).

241. Lyall v. Grayco Builders, Inc., 584 N.Y.S.2d 465, 470 (Sup. Ct. 1992). An additional case, *Froemming v. Gate City Federal Savings & Loan Ass'n*, 822 F.2d 723 (8th Cir. 1986), held that fiduciary duties applied to a partner's self-dealing despite an agreement that permitted partners to benefit from partnership contracts if they were disclosed prior to the transaction. *Id.* at 731. It is unclear whether this case refused to enforce the waiver or found conduct outside of it because the court barely discussed the issue. The partnership agreement provided:

> 8.07: Conflicts of Interest. It is expressly agreed and acknowledged that each of the Partners may engage in, acquire and possess, without limitation or accountability to any of the other Partners, any and all business ventures, professions, callings, pursuits, investments and interests of every nature and description, independently or with others, including, but not limited to, any interest or investment similar to the Partnership property; and it is understood that any Partner may benefit directly or indirectly by virtue of any contract or agreement which the Partnership may enter with any other person or entity in which a Partner may have a direct or indirect interest. However, in the event that a Partner will receive a direct or indirect benefit by virtue of any contract or agreement which the Partnership may enter into, the Partner shall have a duty to disclose such direct or indirect benefit or interest to the Partnership before the Partnership enters into the contract or agreement.

Id. at 731 n.11. The court cryptically added, as its sole discussion of the issue:

> The district court evidently concluded that this provision did not relieve the North Dakota partners of their fiduciary duties in disposing of the mall. We see no error in this conclusion as this paragraph does not explicitly reach the question of what duties the partners owe one another in dealing with partnership property.

Id. at 731.

Burdman, Duignan & Eisenberg[242] held that a contract authorizing partners to compete with the partnership did not permit a partner to use against the partnership inside information that the partnership would not be able to close the deal soon and did not permit the partner to mislead the seller into thinking that the partnership would refuse to buy the property.[243]

3. *"Good Faith"*

One commentator suggests that courts might, in effect, eviscerate fiduciary duty waivers by applying a robust good faith duty notwithstanding the waiver.[244] Properly construed, however, good faith in partnerships differs from fiduciary duties.[245] Fiduciary duties normally are specifically associated with constraints on power delegated to managers. By contrast, good faith is a general principle of interpreting contracts that conserves drafting costs by precluding parties from acting opportunistically according to the letter, but contrary to the spirit, of the contract.[246] In a partnership,

242. 265 Cal. Rptr. 330 (Ct. App. 1989).

243. Tri-Growth Centre City, Ltd. v. Silldorf, Burdman, Duignan & Eisenberg, 265 Cal. Rptr. 330, 336 (Ct. App. 1989).

244. *See* DeMott, *supra* note 214, at 1057-62. For commentary asserting a similarity between good faith and fiduciary duties, see Dickerson, *supra* note 4, at 978-93; Easterbrook & Fischel, *Contract, supra* note 5, at 429-40.

245. This is supported by the separation of good faith and fiduciary duties in RUPA Section 404. However, Section 404(d) and Section 103(b)(5) of RUPA are inconsistent with the definition of good faith proposed here because these provisions identify good faith as a distinct obligation rather than as a means of applying the obligations provided for in the contract.

246. *See* Oregon RSA No. 6, Inc. v. Castle Rock Cellular of Oregon Ltd. Partnership, 840 F. Supp. 770, 776-78 (D. Or. 1993). The court said:

> If in each contract the parties had to expressly describe and prohibit every artifice by which the parties could potentially deprive each other of the fruits of their agreement, then contracts would soon become as long as the tax code, as difficult to interpret, and (like the tax code) still contain innumerable loopholes available to a party that wished to avoid the spirit of its bargain. The better approach . . . is to treat a contract for what it is — an exchange of solemn promises — and enforce the objectively reasonable expectations of the parties. The transaction in question here is an artifice intended to thwart plaintiff's legitimate contractual expectation that it would have a right of first refusal before the partnership interest owned by CRCO could be transferred to someone outside the Cellular family of companies. As such, the Purchase Agreement violates the covenant of good faith and fair dealing that Oregon law implies in every contract. . . . [T]he doctrine of good faith is not a new material term created by the court, but rather a term implied by law in every contract to give effect to the legitimate expectations of the parties that were created by the language of their contract.

Id.

the contract includes the default rules of partnership, which courts should apply in an internally consistent way. For example, unless otherwise agreed, partners share partnership property equally[247] and may not use this property for personal purposes.[248] At the same time, partners have a default power to withdraw and cause a liquidation of the partnership at any time. A partner has a good faith duty not to use this power to usurp partnership property rights inconsistently with the other terms of the partnership contract.[249] By the same token, the fiduciary duty waiver would be one of the partnership terms to which courts must give independent effect in interpreting the partnership agreement under a "good faith" analysis.

C. Preformation Duties

Under the anticontractarian approach to fiduciary duties, certain immutable rules apply irrespective of contract. It follows logically from this theory that fiduciary duties could be imposed on the parties even if they have not contractually elected to be subject to a fiduciary relationship. By contrast, the contractarian approach to fiduciary duties implies that, just as the parties can *waive* default duties that otherwise would be associated with a particular type of relationship, they also should be able to avoid *contracting into* a fiduciary relationship. Moreover, the same policy considerations that favor permitting the parties to vary default duties also justify refusing to recognize fiduciary duties prior to contracting. The appropriate scope of fiduciary duties necessarily depends on the other terms of the parties' contract, particularly including exit, governance, and other constraints on managerial conduct.[250] In the precontractual period, the parties by definition have not agreed on these other terms. Thus, it is unclear precisely what duties should apply. For example, it is not clear what the scope of the parties' duties regarding partnership opportunities should be until the parties agree on how much managerial power to delegate, what the parties' outside opportunities are, and what other monitoring devices will control managerial misconduct. As a result, courts would have to apply a fiduciary duty that did not necessarily fit the particular relationship. This view would force parties to engage in customized contracting, complete with lawyers, at the outset of negotiations rather than when they are finalizing their deal. Moreover, preformation duties would be difficult to waive. Although the

247. *See* UPA § 18(a); RUPA § 401(a).

248. *See* UPA § 25(2)(a).

249. *See* Page v. Page, 359 P.2d 41, 45 (Cal. 1961) (stating in dictum that partner may not appropriate business after dissolution without adequate compensation to copartner).

250. *See supra* Part I.A.

partners could agree in the partnership agreement that results from the negotiations that no fiduciary duties arose prior to the date of the agreement, this tactic will not work if the negotiations break down prior to an agreement or if the court holds that this provision is itself vitiated by pre-agreement nondisclosure.[251]

The contractarian approach — that is, no preformation fiduciary duty — is supported by several cases.[252] As the court said in *Phoenix Mutual Life Insurance Co. v. Shady Grove Plaza Ltd.*,[253] "[a] fiduciary relationship hardly arises when commercial parties engage in contract negotiations."[254] Although the UPA provides that a partner must account for profits "from any transaction connected with *the formation* of the partnership,"[255] this arguably refers to formation of the partnership *business* in the sense of setting up the physical apparatus and contracts with third parties following the partners' reaching agreement on the terms of their relationship.[256] This view would be consistent with the contract analysis of preformation duties. RUPA deletes the confusing reference to duties in formation.[257]

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251. On the other hand, under a no-duty default rule the parties could affirmatively contract, as through a binding "letter of intent," for specific duties during the preformation period. *Cf.* Newharbor Partners, Inc. v. F.D. Rich Co., 961 F.2d 294, 299-300 (1st Cir. 1992) (holding that letter of intent proposing real estate venture, which created some obligations but stated that it did not create legally binding obligations in other respects, did not create mutually intended obligation to act in good faith). The parties could use this device in the relatively infrequent situations in which preformation duties are appropriate, when the parties' negotiations have reached the point that it is less costly for them to rely on legal sanctions than to actively monitor and investigate their potential copartners.

252. *See* Jordan v. McDonald, 803 F. Supp. 493, 496-98 (D. Mass. 1992) (holding that under Massachusetts law, plaintiff was not entitled to treble damages under fraud statute based on fraudulent inducement of her purchase of limited partnership interest because prior to purchase general partner owed no partnership duty to plaintiff); Phoenix Mut. Life Ins. Co. v. Shady Grove Plaza Ltd., 734 F. Supp. 1181, 1191-92 (D. Md. 1990) (holding that there were no good faith or fiduciary duties during negotiations), *aff'd*, 937 F.2d 603 (4th Cir. 1991); Waite *ex rel.* Bretton Woods Acquisition Co. v. Sylvester, 560 A.2d 619, 624-26 (N.H. 1989) (stating that UPA Section 21 does not impose fiduciary duty among prospective partners dealing at arm's length during formation negotiations, here concerning valuation of property transferred by partnership to prospective partner).

253. 734 F. Supp. 1181 (D. Md. 1990).

254. *Phoenix Mut. Life Ins. Co.*, 734 F. Supp. at 1192.

255. UPA § 21 (emphasis added).

256. *But see* Vestal, *Error*, *supra* note 4, at 565-67 (arguing that there are preformation duties under UPA).

257. *See* RUPA § 404.

Several cases *state*, but do not *hold*, that fiduciary duties arise during preformation negotiations. These cases fall into three general categories. First, some cases involve affirmative misrepresentations as distinguished from failures to disclose.[258] Permitting lies would force contracting parties to take costly self-protective actions to investigate statements, whereas requiring parties not to lie does not impose significant burdens on contract negotiators. Accordingly, the duty to refrain from intentional lies is an efficient default rule. By contrast, a general duty to disclose information would be potentially open-ended and would raise the same problems as imposing other preformation fiduciary duties. Second, some of the dicta supporting preformation duties concerns postformation conduct made wrongful by preformation statements or promises.[259] This is nothing more than using the preformation statements to define a contractual duty that does not arise until after the parties form their relationship. Third, there is misleading dicta concerning duties that arise after formation by reason of an enforceable agreement.[260] Fiduciary duties should arise as soon as the parties agree to be governed by a specific set of rules, even if this agreement is preliminary in form — that is, is embodied in a "letter of intent" or similar instrument. In light of the above analysis, the question should be whether the relationship has been sufficiently determined that courts and the parties can know what fiduciary duties should apply and the parties are in a position to enter into a customized contract regarding such duties.

258. *See* Knapp v. First Nat'l Bank & Trust Co., 154 F.2d 395, 396-99 (10th Cir. 1946) (plaintiff allegedly induced to join partnership by fraudulent representations); Lucas v. Abbott, 601 P.2d 1376, 1376 (Colo. 1979) (joint venturer misrepresented his financial condition with misleading balance sheet); Herring v. Offutt, 295 A.2d 876, 878 (Md. 1972) (purchasing partners misrepresented to plaintiff price they would be paying for deceased partner's interest, portion of which they resold to plaintiff); R.C. Gluck & Co. v. Tankel, 199 N.Y.S.2d 12, 14-17 (Sup. Ct. 1960) (partner misrepresented value of property he sold to partnership), *aff'd*, 199 N.Y.S.2d 602 (App. Div. 1961); *see also* Elk River Assocs. v. Huskin, 691 P.2d 1148, 1150 (Colo. Ct. App. 1984) (cause of action for prospectus misrepresentation governed by statute of limitations applicable to confidential relationships).

259. *See* Tobias v. First City Nat'l Bank & Trust Co., 709 F. Supp. 1266, 1277-78 (S.D.N.Y. 1989) (general partner can be held liable under New York law for breach of fiduciary duty for taking or failing to take actions that violated representations made prior to purchase of limited partnership interests during time partnership was in existence); Allen v. Steinberg, 223 A.2d 240, 242-48 (Md. 1965) (involving misconduct during partnership).

260. *See* Maykus v. First City Realty & Fin. Corp., 518 S.W.2d 887, 892-93 (Tex. App. 1974) (discussing duties created by letter of intent that was held to create contractual relationship).

D. A Statutory Approach: The Delaware Law

Delaware has clarified enforceability of waivers by enacting the following provision:

> (c) It is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements.
> (d) To the extent that, at law or in equity, a partner has duties (including fiduciary duties) and liabilities relating thereto to a limited partnership or to another partner, (1) any such partner acting under a partnership agreement shall not be liable to the limited partnership or to any such other partner for the partner's good faith reliance on the provisions of such partnership agreement, and (2) the partner's duties and liabilities may be expanded or restricted by provisions in a partnership agreement.[261]

Arguably, this provision explicitly authorizes only agreements that expand or restrict, rather than eliminate, fiduciary duties.[262] However, this interpretation would ignore the expansive authorization of contracts in subsection (c). Nor is it likely that the statute will be undermined by an expansive application of "good faith" principles, as one commentator has predicted.[263] An important, recent case appears to favor a literal interpretation of the statute. In *U.S. Cellular Investment Co. of Allentown v. Bell Atlantic Mobile Systems, Inc.*,[264] the Delaware Supreme Court held that a complaint alleging the defendant's intentional failure to share certain rights with the plaintiff did not sufficiently plead a breach of fiduciary duty under the above provision because it did not assert a "knowing breach of the agreement."[265]

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261. DEL. CODE ANN. tit. 6, § 17-1101 (1992). The quoted language is from the limited partnership provision. The counterpart LLC provision is similar. *See id.* § 18-1101. For discussions of this provision, see Hynes, *supra* note 3, at 49-50, and see generally Larry E. Ribstein, *Unlimited Contracting in the Delaware Limited Partnership and Its Implications for Corporate Law*, 16 J. CORP. L. 299 (1991).

262. *See* DeMott, *supra* note 214, at 1057.

263. *See id.* at 1057-62.

264. 677 A.2d 497 (Del. 1996).

265. U.S. Cellular Inv. Co. of Allentown v. Bell Atlantic Mobile Sys., Inc., 677 A.2d 497, 504 (Del. 1996). For additional cases supporting a broad interpretation of the Delaware provision, see *Whalen v. Connelly*, 545 N.W.2d 284 (Iowa 1996) (relying on Delaware statute and holding that it was not breach as matter of law for general partner or its affiliate to engage in riverboat gambling projects in other states without offering limited partner opportunity to participate because partnership agreement permitted general partners to engage in other similar activities), and *Rothmeier v. Investment Advisers, Inc.*, 556 N.W.2d 590 (Minn. Ct. App. 1996) (holding that, under Delaware statute, partnership may terminate partner in compliance with partnership agreement in absence of evidence that partner's investigation of firm's securities registration was improper motivating factor in his termination).

E. Indirect Waiver: Selecting the Default Rules

Consistent with the contractual theory, the parties not only can *directly* choose to waive fiduciary duties, but also can do so indirectly by choosing the applicable state law, one of several standard forms offered by each state, and what their status will be within a given standard form.

1. Choice of Applicable State Law

The parties have long been able to designate the applicable state law in their partnership agreement. Because the UPA does not include a choice of law provision, general common-law rules on choice of law apply to general partnerships. Under these rules, a contractual choice of law clause may not be enforced with respect to the validity of a contractual provision such as a fiduciary duty waiver if (a) the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties' choice, or (b) application of the law of the chosen state would be contrary to a fundamental policy of a state that has a materially greater interest than the chosen state in the determination of the particular issue and that, under the rule of Section 188 of the *Restatement (Second) of Conflict of Laws*, would be the state of the applicable law in the absence of an effective choice of law by the parties.[266]

Despite the application of these general rules, courts have almost invariably applied contractual choice of law to partnerships.[267] In one recent

266. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187(2) (1971).

267. *See* Exxon Corp. v. Burglin, 4 F.3d 1294, 1298 & n.5 (5th Cir. 1993) (stating that clause in partnership agreement which applied Alaska law was enforceable when oil leases, subject of partnership, were located in Alaska although Settlement Agreement was predominately negotiated, drafted, and executed in Texas and partnership involved several Texas companies); Great Lakes Overseas, Inc. v. Wah Kwong Shipping Group, Ltd., 990 F.2d 990, 994 (7th Cir. 1993) (applying English law as selected in parties' agreement to determine if freight liner service and corporation were partners); Spitzer v. Shanley Corp., 870 F. Supp. 565, 570 (S.D.N.Y. 1994) (holding that Oklahoma law governed fiduciary duty of corporate general partner although that partner was incorporated in Texas); Ryan v. Brophy, 755 F. Supp. 595, 597 (S.D.N.Y. 1991) (holding that New York law governed suit by former partnership employee against principal members of partnership when employment contract forming basis of employee's claims provided for application of New York law, partners were citizens of New York, and partnership had its principal place of business in New York); Seidman & Seidman v. Wolfson, 123 Cal. Rptr. 873, 876 (Ct. App. 1975) (holding that choice of law provision was properly enforced below and reasoning that fraud which vitiates contractual choice of law clause must be in connection with clause itself); Crowe v. Smith, 603 So. 2d 301, 308 (Miss. 1992) (applying Mississippi law in dissolution of partnership that owned Louisiana property but was characterized as "Mississippi partnership" on basis of parties' agreement supplemented by general choice of law principles); Engel v. Ernst, 724

case, a Texas court applied Alaska law on the enforceability of a waiver of fiduciary disclosure duties despite the facts that the agreement was predominately negotiated, drafted, and executed in Texas and that the partnership involved several Texas companies.[268]

Any question about whether courts will enforce contractual choice of law clauses is being eliminated by statutes that provide for enforcement of choice of law clauses in commercial agreements,[269] by RUPA, which clarifies that the default rules on choice of law are subject to contrary agreement,[270] and by LLC,[271] LLP,[272] and limited partnership[273] statutes that explicitly provide for registration of foreign entities and for application of these entities' formation state law. As a result of enforcement of contractual choice of law, the parties can choose to be governed by the broad Delaware opt-out provisions discussed above.[274] In general, the combination of the Delaware statute and the expansion of enforcement of contractual choice of law suggests that truly mandatory fiduciary duties are virtually a dead issue.[275]

P.2d 215, 216-18 (Nev. 1986) (holding that agreement governing accounting firm headquartered in Colorado that provided for application of Colorado law controlled interpretation of provision on amounts due from retiring partner under agreement to pay fees that firm would have earned from partnership clients that withdrawing partner serviced during two years following withdrawal; reasoning that only Nevada's "strong public policy" may prevent enforcement of choice of law clause; and concluding that lower court erred in finding such policy because agreement did not eliminate competition, defendant could and did join new firm, and firm had legitimate interest in protecting its client base and providing for liquidated damages). *But see* Intercontinental Leasing v. Anderson, 410 F.2d 303, 305 (10th Cir. 1969) (applying joint and several liability under Kansas law rather than joint liability under Minnesota law despite Minnesota choice of law clause when contract was made and performed in Kansas). For a more detailed discussion of enforcement of contractual choice of law, see Larry E. Ribstein, *Choosing Law by Contract*, 18 J. CORP. L. 245, 261-66 (1993).

268. *See* Exxon Corp. v. Burglin, 4 F.3d 1294, 1298 & n.5 (5th Cir. 1993); *supra* text accompanying notes 198-200 (discussing *Burglin*).

269. *See* 1 BROMBERG & RIBSTEIN, *supra* note 22, § 1.04(C), at 1:72-:75.

270. *See* RUPA § 103 (not including choice of law in exclusive list of provisions that cannot be waived in partnership agreement); 1 BROMBERG & RIBSTEIN, *supra* note 22, § 1.04(d), at 1:75-:77.

271. *See* LARRY E. RIBSTEIN & ROBERT KEATINGE, RIBSTEIN & KEATINGE ON LIMITED LIABILITY COMPANIES 13-1 to 13-33 (1994 & Supp. 1997).

272. ALAN A. BROMBERG & LARRY E. RIBSTEIN, BROMBERG & RIBSTEIN ON LIMITED LIABILITY PARTNERSHIPS AND THE REVISED UNIFORM PARTNERSHIP ACT Ch. 6 (1995).

273. *See* REVISED UNIF. LIMITED PARTNERSHIP ACT § 901, 6A U.L.A. 254 (1995); 3 BROMBERG & RIBSTEIN, *supra* note 22, § 12.25(b), at 12:267-12:269.

274. *See supra* Part III.D.

275. As discussed below in Part III.E.4, the parties could choose to be governed by *mandatory* rules. However, as explained below, the parties would be *contracting* for binding

2. *Choice of Fiduciary Status*

The parties may choose the standard form that will provide the default rules for their relationship, including whether these rules will be those of a nonfiduciary relationship. For example, several cases hold that parties who were in a debtor-creditor rather than a partnership relationship did not owe fiduciary duties.[276] One might argue that creditors do not need fiduciary duties because of their specific rights to repayment of their debts with interest.[277] However, this general reasoning could be extended to any situation in which the parties substitute other constraints for fiduciary duties.[278] Moreover, this reasoning does not explain why fiduciary duties are not owed by one who contracts at arm's length to provide services to the firm[279] or to one who chooses to be an assignee rather than a partner,[280] or why one might be able to avoid the full force of fiduciary remedies by organizing a partner as a corporation or other limited liability entity.[281] The

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fiduciary duties rather than being subjected to fiduciary duties despite a contrary provision in their contract.

276. *See* Tuxedo Beach Club Corp. v. City Fed. Sav. Bank, 749 F. Supp. 635, 646-47 (D.N.J. 1990) (noting that fiduciary principles should not be applied to arm's length debtor-creditor relationship in absence of partnership).

277. For a leading case denying fiduciary duties to creditors of corporations, see *Katz v. Oak Industries, Inc.*, 508 A.2d 873, 879 (Del. Ch. 1986).

278. *See supra* Part I.C.

279. *See* Bernard Weinraub, *Analysis: Behind Sony Ouster, One Excess Too Many*, N.Y. TIMES, Dec. 7, 1995, at D1 (discussing arm's length deal between Peter Guber and Sony Studios that allowed Guber to "selectively pluck film projects nurtured by Columbia and Tristar executives and hand their production over to his own company, Mandalay Entertainment").

280. *See* Bauer v. Blomfield Company/Holden Joint Venture, 849 P.2d 1365, 1367 (Alaska 1993) (holding that partners owe no duty to assignee to act in good faith, so assignee could not question partners' decision to pay large commission to copartner, which stopped income payments to assignee). Similarly, one who withdraws as a partner but continues to receive payments from the firm is a mere assignee who is not owed continuing fiduciary duties. *See* Hoffman Elec., Inc. v. Emerson Elec. Co., 800 F. Supp. 1279, 1284-85 (W.D. Pa. 1992) (holding that general partner had no fiduciary duty to former limited partners in dissolved limited partnership); Bane v. Ferguson, 707 F. Supp. 988, 991-92 (N.D. Ill.) (holding that continuing partners had no fiduciary duty liability to retired partner for dissolution of firm that caused cessation of retirement benefits), *aff'd*, 890 F.2d 11 (7th Cir. 1989); Finkelstein v. Security Properties, Inc., 888 P.2d 161, 167 (Wash. Ct. App. 1995) (holding that ongoing partners who continue firm after dissolution probably have no fiduciary duty to withdrawn partners to refrain from self-dealing, because dissociated partner's share is fixed at time of withdrawal and therefore is unaffected by any subsequent conduct).

281. For cases holding that fiduciary duties are owed by incorporated partners rather than their controlling managers or shareholders, see *Maywalt v. Parker & Parsley Petroleum*

assignee example should be particularly puzzling for anticontractarians because an assignee, like her owner-assignor, is a residual claimant and yet is even more vulnerable than an owner to partners' misdealing because she lacks any management role in the partnership. Nor can the assignee necessarily rely on the assignor-partner to exercise her rights on behalf of the assignee because the assignor may lack any incentive to do so. Of course, the assignee can attempt to contract with her assignor or with the other partners for specific protection, such as the assignor's promise to monitor the firm and pursue fiduciary remedies when appropriate. But this begs the question why the assignee is not legally entitled to such protection. Thus, these cases are not easily explained by generalities about when fiduciary duties are appropriate. Rather, they demonstrate judicial recognition of the principle that the contracting parties themselves are best able to decide when fiduciary duties fit their relationship.

3. *Choice of Form*

The parties may choose from a menu of business forms offered by each state, including corporations, limited partnerships, and limited liability companies, in addition to partnerships. Some of these statutes may have more explicit waiver provisions than the general partnership statute. For example, the Delaware provisions discussed above[282] are only in the Delaware limited partnership and limited liability company statutes. It may be that, given the proliferation of unincorporated business forms, states will design their general partnership statutes for the simplest firms and other statutes for more sophisticated firms that customize their agreements.[283] In that event, states might provide somewhat stricter waiver rules for general partnerships than for LLCs and similar firms.

4. *Contracting for Mandatory Rules*

The parties' ability to choose the applicable law, form, or relationship might have the surprising implication of *supporting* the enforcement of "mandatory" fiduciary duty rules. A statutory antiwaiver rule is not necessarily inconsistent with the contractarian position as long as there is no

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Co., 808 F. Supp. 1037, 1058-59 (S.D.N.Y. 1992) (applying Texas and Pennsylvania law), and *Sturm v. Goss*, 368 S.E.2d 399, 401 (N.C. Ct. App. 1988). Some cases have, however, imposed liability directly on owners in this situation on a variety of theories, including veil-piercing, agency, or direct control. *See* 2 BROMBERG & RIBSTEIN, *supra* note 22, § 6.07, at 6:68.

282. *See supra* Part III.D.

283. *See supra* Part II.G.3.

impediment to organizing the business relationship under different default rules or adopting a customized contract.[284] Such a rule would permit states to protect the most vulnerable relationships and at the same time let firms contract for binding fiduciary duties that could not be changed by a subsequent amendment of the contract.[285] If, however, courts or legislatures widen the effect of the antiwaiver rule by, for example, applying it even to firms that are formed under foreign-state statutes or under other standard forms, or by holding that certain types of relationships necessarily are partnerships that are subject to the rule even if they are not designated as partnerships, then this is an anticontractarian position that is subject to the same criticisms as those directed in this Article against antiwaiver rules.[286] Moreover, it is important to emphasize that fiduciary duties are not *now* mandatory in any unincorporated business forms.

F. A Positive Analysis of the Uniform Laws

This Part has shown that the case law provides overwhelming support for enforcement of fiduciary waivers. Nevertheless, RUPA and the ULLCA[287] include significant limitations on fiduciary duty waivers. RUPA provides that the partners may not:

> (3) eliminate the duty of loyalty under Section 404(b) or 603(b)(3), but:

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284. There may be such an impediment if, for example, it is more costly for a firm to obtain certain business features under a statute that permits fiduciary duty waiver than under a statute that does not.

285. The ability to agree to binding rules is an important contractual value that is lost when legislatures change the rules and apply the changes to existing partnerships. *See* Larry E. Ribstein, *Changing Statutory Forms*, 1 J. SM. BUS. L. (forthcoming 1997) (available on the Internet at: <http://mason.gmu.edu/~lribstei/index.htm). The extent to which legislatures can and do change rules is a function of legislative control over business associations through both mandatory rules and restrictions on choice of law.

286. Similar considerations would apply to proposals by commentators to allow contracting, but only by selecting from a limited menu proposed by the commentators. *See* Coffee, *Mandatory/Enabling Balance*, *supra* note 6, at 1664-76 (proposing to permit parties to adopt "brand name" alternatives to mandatory rules); Vestal, *Error*, *supra* note 4, at 578 n.238 (proposals to permit opt-in to particular type of partnership); Weidner, *supra* note 4, at 107 (suggesting that partnership should be reserved for informal relationships of highly interdependent). One anticontractarian makes clear her hostility to contracting through choice of form. *See* Dickerson, *supra* note 87, at 400 (criticizing breakdown of mandatory fiduciary duties that is heralded by new availability of more contractual forms such as LLC).

287. ULLCA § 103(b)(2)-(4). These provisions correspond closely to the RUPA provisions and therefore will not be discussed separately.

(i) the partnership agreement may identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable; or
(ii) all of the partners or a number or percentage specified in the partnership agreement may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty;
(4) unreasonably reduce the duty of care under Section 404(c) or 603(b)(3);
(5) eliminate the obligation of good faith and fair dealing under Section 404(d), but the partnership agreement may prescribe the standards by which the performance of the obligation is to be measured, if the standards are not manifestly unreasonable.[288]

The precise meaning of these vague and contradictory provisions is open to question. Some commentators assert that these provisions prevent only complete elimination of fiduciary duties.[289] But the language is susceptible to broader interpretations that are inconsistent not only with the policy considerations discussed in Parts I and II, but also with the case law discussed in this Part. The restriction of duty of loyalty waivers to "specific types or categories of activities" could be interpreted to require identification of specific conduct, such as acquisition of property, rather than merely a type of wrong, such as self-dealing. This would invalidate the agreement in *Singer v. Singer*,[290] which provided that "[e]ach partner shall be free to enter into business and other transactions for his or her own separate individual account, even though such business or other transaction may be in conflict with and/or competition with the business of the partnership."[291] There is also no case law authority justifying judicial scrutiny of the "reasonableness" of fiduciary duty waivers similar to the RUPA limitation of duty of care waivers. And requiring the parties to identify good faith "standards" that are not "manifestly unreasonable" is not only hopelessly vague but also inconsistent with the concept of good faith discussed in this Article.[292]

288. RUPA § 103(b)(3)-(5). ULLCA Section 103(b)(2)-(4) corresponds closely to these provisions and therefore will not be discussed separately.

289. *See* Vestal, *Response*, *supra* note 4, at 64; Weidner, *supra* note 4, at 93 (showing how RUPA Section 103 could be interpreted even to permit the broad waiver in *Singer v. Singer*, discussed *supra* text accompanying note 173).

290. 634 P.2d 766 (Okla. Ct. App. 1981).

291. Singer v. Singer, 634 P.2d 766, 768 (Okla. Ct. App. 1981); *see supra* text accompanying note 173 (discussing *Singer*). It would also invalidate the agreement in *Dremco*, discussed *supra* notes 177-78.

292. As discussed in *supra* Part III.B, good faith is a mechanism of contract interpreta-

IV. Concluding Remarks

Fiduciary duties should be broadly waivable in partnerships and other unincorporated firms. Because the costs and benefits of fiduciary duties vary from firm to firm, these duties must be varied to suit the particular relationship. The parties themselves are in a far better position than courts to determine precisely what level of duties should apply to their relationship. Anticontractarians' arguments against enforcing fiduciary duty waivers are deeply flawed and overbroad. The appropriate rule is the one set forth in the Delaware limited partnership and LLC statutes:[293] the parties should be able to alter default duties in their agreements as long as they are held to good faith compliance with their contracts. A close look at the case law shows that this is, in fact, the approach courts now apply.

This Article has broader lessons concerning the importance of deeper analysis of the sometimes vague area of fiduciary duties. Normative analysis should focus on specific problems that may be caused by permitting waivers rather than making broad and conclusory statements about inefficiency and injustice. A concern for norms and morality does not make analysis unnecessary. It is also time that the commentators drew conclusions only from close examination of large numbers of cases rather than relying on sporadic dicta. The recent literature on fiduciary duty waivers in partnerships has been dominated by academics who have sought to impose their own unsupported views on controversies in which they have no stake. It is time that a more lawyer-like attention to logic and facts reclaimed the debate over this issue.

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tion. Properly understood in this way, it is hard to see how the parties can waive the good faith obligation at all. It follows that RUPA Section 404 probably represents an alternative and incorrect view of good faith as a standard of conduct that is independent of the contract.

293. *See supra* Part III.D.